

AMERICAN SAFETY INSURANCE HOLDINGS LTD  
Form 10-Q  
August 10, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

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**FORM 10 Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2009

“OR”

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO.

Commission File Number 1-14795

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD.**  
(Exact name of Registrant as specified in its charter)

Bermuda  
(State or other jurisdiction  
of incorporation)

Not Applicable  
(I.R.S. Employer  
Identification No.)

The Boyle Building, 2<sup>nd</sup> Floor  
31 Queen Street  
Hamilton, HM 11, Bermuda  
(Address, zip code of principal executive offices)

(441) 296-8560  
(Registrant's telephone number, including area code)

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Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one)

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The aggregate number of shares outstanding of Registrant's common stock, \$0.01 par value, on August 4, 2009 was 10,320,153.

AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

**FORM 10-Q**

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Balance Sheets

(dollars in thousands except per share data)

| <u>Assets</u>                                   | <u>June 30, 2009</u><br><u>(Unaudited)</u> | <u>December 31, 2008</u> |
|---|--|--------------------------|
| Investments:                                    |  |                          |
| Fixed maturity securities available for sale,   |  |                          |
| at fair value                                   | \$ 604,639                                 | \$ 569,910               |
| Common stock, at fair value                     | 14,588                                     | 20,537                   |
| Preferred stock, at fair value                  | 2,903                                      | 3,287                    |
| Short-term investments, at fair value           | <u>111,265</u>                             | <u>80,005</u>            |
| Total investments                               | 733,395                                    | 673,739                  |
| Cash and cash equivalents                       | 14,591                                     | 12,898                   |
| Accrued investment income                       | 5,653                                      | 6,214                    |
| Premiums receivable                             | 18,400                                     | 19,917                   |
| Ceded unearned premiums                         | 26,110                                     | 36,118                   |
| Reinsurance recoverable                         | 200,526                                    | 199,455                  |
| Deferred income taxes                           | 9,238                                      | 11,784                   |
| Deferred policy acquisition costs               | 17,637                                     | 18,171                   |
| Property, plant and equipment, net              | 10,488                                     | 10,976                   |
| Goodwill  | 11,128                                     | 9,696                    |
| Other assets                                    | <u>39,735</u>                              | <u>27,396</u>            |
| Total assets                                    | <u>\$1,086,901</u>                         | <u>\$1,026,364</u>       |
| <br><u>Liabilities and Shareholders' Equity</u> |  |                          |
| Liabilities:                                    |  |                          |
| Unpaid losses and loss adjustment expenses      | \$ 605,478                                 | \$ 586,647               |
| Unearned premiums                               | 108,861                                    | 122,259                  |
| Ceded premiums payable                          | 16,568                                     | 20,732                   |
| Deferred revenues                               | 1,823                                      | 1,770                    |
| Accounts payable and accrued expenses           | 11,627                                     | 8,586                    |
| Deferred rent                                   | 1,391                                      | 1,626                    |
| Funds held                                      | 35,427                                     | 25,684                   |
| Securities payable                              | 19,645                                     | -                        |

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|                   |                   |                   |
|-------------------|-------------------|-------------------|
| Loans payable     | <u>37,479</u>     | <u>38,932</u>     |
| Total liabilities | <u>\$ 838,299</u> | <u>\$ 806,236</u> |

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|   | June 30,<br>2009<br><u>(Unaudited)</u> | <u>December 31, 2008</u> |
|---|--|--------------------------|
| Shareholders' equity  |  |                          |
| Preferred stock, \$0.01 par value; authorized 5,000,000 shares; no shares issued and outstanding  | \$ -                                   | \$ -                     |
| Common stock, \$0.01 par value; authorized 30,000,000 shares; issued and outstanding at June 30, 2009, 10,302,511 and December 31, 2008, 10,274,368 |  |                          |
| Additional paid-in capital  | 103<br>101,630                         | 103<br>100,645           |
| Retained earnings   | 131,960                                | 119,491                  |
| Accumulated other comprehensive income (loss), net  | <u>11,496</u>                          | <u>(3,209)</u>           |
| Total American Safety Insurance Holdings shareholders' equity   | <u>245,189</u>                         | <u>217,030</u>           |
| Equity in non-controlling interest  | 3,413                                  | 3,098                    |
| Total shareholders' equity  | <u>248,602</u>                         | <u>220,128</u>           |
| Total liabilities and shareholders' equity  | 1,086,901                              | \$1,026,364              |
| Book value per share  | \$23.80                                | \$21.12                  |
| Diluted book value per share  | \$22.96                                | \$20.55                  |

See accompanying notes to consolidated interim financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

## Consolidated Statements of Operations

(Unaudited)

(dollars in thousands except per share data)

|  | Three Months Ended |                 | Six Months Ended |                  |
|--|--------------------|-----------------|------------------|------------------|
|  | June 30,           |                 | June 30,         |                  |
|  | <u>2009</u>        | <u>2008</u>     | <u>2009</u>      | <u>2008</u>      |
| <b>Revenues:</b>   |                    |                 |                  |                  |
| Direct premiums earned   | \$50,401           | \$47,903        | \$101,179        | \$ 94,271        |
| Assumed premiums earned  | 9,056              | 14,419          | 20,096           | 22,113           |
| Ceded premiums earned  | <u>(17,867)</u>    | <u>(14,180)</u> | <u>(35,006)</u>  | <u>(30,193)</u>  |
| Net premiums earned  | <u>41,590</u>      | <u>48,142</u>   | <u>86,269</u>    | <u>86,191</u>    |
| Net investment income  | 7,729              | 7,316           | 15,519           | 14,643           |
| Net realized gains   | 281                | 291             | 237              | 795              |
| Fee income   | 1,184              | 791             | 2,118            | 1,518            |
| Other income   | <u>66</u>          | <u>16</u>       | <u>84</u>        | <u>30</u>        |
| Total revenues   | <u>50,850</u>      | <u>56,556</u>   | <u>104,227</u>   | <u>103,177</u>   |
| <b>Expenses:</b>   |                    |                 |                  |                  |
| Losses and loss adjustment expenses                                      | 24,175             | 30,380          | 51,248           | 52,410           |
| Acquisition expenses   | 8,873              | 11,962          | 19,077           | 21,038           |
| Payroll and related expenses   | 5,704              | 5,374           | 11,521           | 9,859            |
| Other underwriting expenses  | 2,766              | 3,000           | 5,795            | 6,316            |
| Interest expense   | 810                | 824             | 1,551            | 1,655            |
| Corporate and other expenses   | <u>744</u>         | <u>(1,882)</u>  | <u>1,425</u>     | <u>(1,306)</u>   |
| Total expenses   | 43,072             | 49,658          | 90,617           | 89,972           |
| Earnings before income taxes   | 7,778              | 6,898           | 13,610           | 13,205           |
| Income taxes   | <u>766</u>         | <u>95</u>       | <u>974</u>       | <u>243</u>       |
| Net earnings   | <u>\$ 7,012</u>    | <u>\$ 6,803</u> | <u>\$ 12,636</u> | <u>\$ 12,962</u> |
| <hr style="border: 1px solid black;"/>                                   |                    |                 |                  |                  |
| Less: Net earnings attributable to the<br>Non-controlling interest       | <u>93</u>          | <u>14</u>       | <u>172</u>       | <u>152</u>       |
| Net earnings attributable to American Safety<br>Insurance Holdings, Ltd. | <u>\$ 6,919</u>    | <u>\$ 6,789</u> | <u>\$ 12,464</u> | <u>\$ 12,810</u> |
| <hr style="border: 1px solid black;"/>                                   |                    |                 |                  |                  |

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Net earnings per share:

|         |                |                |                |                |
|---------|----------------|----------------|----------------|----------------|
| Basic   | <u>\$ 0.67</u> | <u>\$ 0.64</u> | <u>\$ 1.21</u> | <u>\$ 1.21</u> |
| Diluted | <u>\$ 0.66</u> | <u>\$ 0.63</u> | <u>\$ 1.19</u> | <u>\$ 1.18</u> |

Weighted average number of shares outstanding:

|         |                   |                   |                   |                   |
|---------|-------------------|-------------------|-------------------|-------------------|
| Basic   | 10,302,511        | 10,543,397        | 10,294,390        | 10,619,552        |
| Diluted | <u>10,523,511</u> | <u>10,803,446</u> | <u>10,515,391</u> | <u>10,896,841</u> |

See accompanying notes to consolidated interim financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

## Consolidated Statements of Cash Flow

(Unaudited)

(dollars in thousands)

|   | Six Months Ended |                 |
|---|------------------|-----------------|
|   | June 30,         |                 |
|   | <u>2009</u>      | <u>2008</u>     |
| Cash flow from operating activities:  |                  |                 |
| Net earnings  | \$ 12,636        | \$ 12,962       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                  |                 |
| Net realized gains on sale of investments   | (237)            | (795)           |
| Depreciation expense  | 1,843            | 2,074           |
| Stock based compensation expense  | 994              | 517             |
| Amortization of deferred acquisition costs, net                                     | 591              | (3,322)         |
| Amortization of premiums on investments   | 570              | 233             |
| Deferred income taxes   | (558)            | 406             |
| Change in operating assets and liabilities  |                  |                 |
| Accrued investment income   | 572              | (600)           |
| Premiums receivable   | 2,012            | (13,709)        |
| Reinsurance recoverable   | (1,071)          | (5,075)         |
| Ceded unearned premiums   | 10,008           | (1,043)         |
| Funds held  | 9,743            | (3,602)         |
| Unpaid losses and loss adjustment expenses  | 17,911           | 32,977          |
| Unearned premiums   | (13,706)         | 10,600          |
| Ceded premiums payable  | (4,164)          | (11,916)        |
| Deferred revenues   | 53               | (46)            |
| Accounts payable and accrued expenses   | 2,577            | (2,668)         |
| Deferred rent   | (235)            | (74)            |
| Other assets  | <u>(11,923)</u>  | <u>(16,429)</u> |
| Net cash provided by operating activities   | <u>27,616</u>    | <u>490</u>      |
| Cash flow from investing activities:  |                  |                 |
| Purchases of fixed maturities   | \$ (130,725)     | \$ (98,704)     |
| Purchases of common stock   | (162)            | (2,778)         |
| Proceeds from sale of fixed maturities  | 130,789          | 90,364          |
| Proceeds from sale of equity securities   | 8,189            | 151             |
| Consideration paid for acquired companies, net                                      | (3,688)          | (8,927)         |
| (Increase) decrease in short-term investments                                       | (29,173)         | 19,584          |
| Purchase of fixed assets  | <u>(1,157)</u>   | <u>(2,623)</u>  |
| Net cash used in investing activities   | <u>(25,927)</u>  | <u>(2,933)</u>  |

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(dollars in thousands)

|  | Six Months Ended |                |
|--|------------------|----------------|
|  | June 30,         |                |
|  | <u>2009</u>      | <u>2008</u>    |
| Cash flow from financing activities:                 |                  |                |
| Repurchase of common stock                           | \$ (430)         | \$ (4,107)     |
| Proceeds from exercised stock options                | <u>434</u>       | <u>375</u>     |
| Net cash provided by (used in) financing activities  | <u>4</u>         | <u>(3,732)</u> |
| Net increase (decrease) in cash and cash equivalents | 1,693            | (6,175)        |
| Cash and cash equivalents at beginning of period     | <u>12,898</u>    | <u>12,860</u>  |
| Cash and cash equivalents at end of period           | \$14,591         | \$ 6,685       |
| Supplemental disclosure of cash flow information:    |                  |                |
| Income taxes paid                                    | \$ 1,908         | \$ 89          |
| Interest paid  | \$ 1,544         | \$ 1,563       |

See accompanying notes to consolidated interim financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Comprehensive Earnings

(Unaudited)

(dollars in thousands)

|  | Three Months Ended |                | Six Months Ended |                |
|--|--------------------|----------------|------------------|----------------|
|  | June 30,           |                | June 30,         |                |
|  | <u>2009</u>        | <u>2008</u>    | <u>2009</u>      | <u>2008</u>    |
| Net earnings   | \$ 7,012           | \$ 6,803       | \$ 12,636        | \$ 12,962      |
| Other comprehensive income   |                    |                |                  |                |
| before income taxes:   |                    |                |                  |                |
| Unrealized gains (losses) on securities available-for-sale                           | 20,214             | (11,551)       | 16,616           | (10,956)       |
| Unrealized gains (losses) on hedging transactions                                    | 2,108              | 16             | 1,518            | (104)          |
| Reclassification adjustment for realized losses included in net earnings             | <u>(281)</u>       | <u>(291)</u>   | <u>(237)</u>     | <u>(795)</u>   |
| Total other comprehensive income (loss) before taxes                                 | 22,041             | (11,826)       | 17,897           | (11,855)       |
| Income tax (benefit) expense related to items of other comprehensive income          | <u>4,121</u>       | <u>(2,007)</u> | <u>3,098</u>     | <u>(1,862)</u> |
| Other comprehensive income (loss) earnings net of income taxes                       | <u>17,920</u>      | <u>(9,819)</u> | <u>14,799</u>    | <u>(9,993)</u> |
| Comprehensive income (loss)  | 24,932             | (3,016)        | 27,435           | 2,969          |
| Less: Comprehensive income (loss) attributable to the non-controlling interest       | <u>177</u>         | <u>(45)</u>    | <u>266</u>       | <u>83</u>      |
| Comprehensive income (loss) attributable to American Safety Insurance Holdings, Ltd. | \$ 24,755          | \$ (2,971)     | \$ 27,169        | \$ 2,886       |

See accompanying notes to consolidated interim financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

Notes to Consolidated Financial Statements

June 30, 2009

(Unaudited)

## **Note 1 - Basis of Presentation**

The accompanying consolidated financial statements of American Safety Insurance Holdings, Ltd. ("American Safety Insurance") and its subsidiaries and American Safety Risk Retention Group, Inc. ("American Safety RRG"), a non-subsiary risk retention group affiliate (collectively, the "Company"), are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates, based on the best information available, in recording transactions resulting from business operations. The balance sheet amounts that involve a greater extent of accounting estimates and/or actuarial determinations subject to future changes are the Company's invested assets, deferred income taxes, reinsurance recoverables, goodwill and the liabilities for unpaid losses and loss adjustment expenses. As additional information becomes available (or actual amounts are determinable), the recorded estimates may be revised and reflected in operating results. While management believes that these estimates are adequate, such estimates may change in the future.

The results of operations for the six months ended June 30, 2009 may not be indicative of the results that may be expected for the fiscal year ending December 31, 2009. These unaudited interim consolidated financial statements and notes should be read in conjunction with the financial statements and notes included in the audited consolidated financial statements on Form 10-K of the Company for the fiscal year ended December 31, 2008.

The unaudited interim consolidated financial statements include the accounts of American Safety Insurance, each of its subsidiaries and American Safety RRG. All significant intercompany balances as well as normal recurring adjustments have been eliminated.

Certain balance sheet and statement of operations items have been reclassified for the periods ending June 30, 2008 and December 31, 2008. The presentation is consistent with the presentation for the three and six months ended June 30, 2009 and did not result in any impact to net earnings or shareholders' equity.

## **Note 2 - Nature of Operations**

We are a Bermuda-based specialty insurance and reinsurance company that provides customized products and solutions to small and medium-sized businesses in industries that we believe are underserved by the standard market. For over twenty years we have developed specialized coverages and alternative risk transfer products not generally available to our customers in the standard market because of the unique characteristics of the risks involved and the associated needs of the insureds. We specialize in underwriting these products for insureds with certain environmental, products liability, construction, healthcare and property risks, as well as developing programs for other specialty classes of risks and providing third party reinsurance. See Part II – Other Information, Item 1A for risks facing the Company.



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**Note 3 - Investments**

The amortized cost and estimated fair values of the Company's investments at June 30, 2009 and December 31, 2008 are as follows (dollars in thousands):

|   | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Estimated<br>fair value |
|---|-------------------|------------------------------|-------------------------------|-------------------------|
| <u>June 30, 2009</u>  |                   |                              |                               |                         |
| Securities available for sale:  |                   |                              |                               |                         |
| Fixed maturities:   |                   |                              |                               |                         |
| U.S. Treasury securities and obligations of<br>U.S. Government corporations and agencies \$ 110,584<br>States of the U.S. and political subdivisions<br>of the states | 38,588            | \$ 2,323                     | \$ (454)                      | \$ 112,453              |
| Corporate securities  | 202,475           | 825                          | (604)                         | 38,809                  |
| Mortgage-backed securities  | 184,179           | 8,146                        | (1,496)                       | 209,125                 |
| Commercial mortgage-backed securities   | 28,602            | 6,707                        | -                             | 190,886                 |
| Asset-backed securities   | <u>22,642</u>     | <u>2,706</u>                 | <u>(774)</u>                  | <u>30,534</u>           |
|   |                   | <u>297</u>                   | <u>(107)</u>                  | <u>22,832</u>           |
| Total fixed maturities  | \$ 587,070        | \$ 21,004                    | \$ (3,435)                    | \$ 604,639              |
| Common stock  | \$ 18,077         | \$ 184                       | \$ (3,673)                    | \$ 14,588               |
| Preferred stock   | \$ 3,273          | \$ 59                        | \$ (429)                      | \$ 2,903                |
| <u>December 31, 2008:</u>   |                   |                              |                               |                         |
| Securities available for sale:  |                   |                              |                               |                         |
| Fixed maturities:   |                   |                              |                               |                         |
| U.S. Treasury securities and obligations of<br>U.S. Government corporations and agencies \$ 57,335  |                   | \$ 4,874                     | \$ -                          | \$ 62,209               |
| States of the U.S. and political subdivisions<br>of the states  | 41,804            | 479                          | (692)                         | 41,591                  |
| Corporate securities  | 256,141           | 6,467                        | (10,669)                      | 251,939                 |
| Mortgage-backed securities  | 181,032           | 5,126                        | -                             | 186,158                 |



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|                                       |               |           |              |               |
|---------------------------------------|---------------|-----------|--------------|---------------|
| Commercial mortgage-backed securities | 14,097        | -         | (2,179)      | 11,918        |
| Asset-backed securities               | <u>17,006</u> | <u>3</u>  | <u>(914)</u> | <u>16,095</u> |
| Total fixed maturities                | \$ 567,415    | \$ 16,949 | \$(14,454)   | \$569,910     |
| Common stock                          | \$ 25,425     | \$ 975    | \$(5,863)    | \$ 20,537     |
| Preferred stock                       | \$ 3,785      | \$ 11     | \$ (509)     | \$ 3,287      |

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**Note 4 - Segment Information**

We segregate our business into insurance operations and other, with the insurance operations segment being further classified into three lines of operation: excess and surplus lines (E&S), alternative risk transfer (ART) and assumed reinsurance (Assumed Re). E&S is further classified into seven business lines: property, environmental, construction, products liability, excess, surety and healthcare. ART is further classified into two business lines: specialty programs and fully funded. Assumed Re consists of specialty property and casualty business assumed from unaffiliated specialty insurers and reinsurers. Other includes lines of business that we no longer write (run-off) as well as real estate and other ancillary product lines. Prior year amounts have been reclassified to conform to the current year presentation.

Within the E&S line, our property coverage encompasses non-standard, surplus lines commercial property business and commercial multi-peril (CMP) policies. The casualty focus of our CMP products is premises liability. Our environmental insurance group provides general, professional and pollution liability to contractors, consultants and property owners. Construction provides commercial general liability insurance coverages for residential and commercial contractors. Products liability offers general liability and product liability coverages for smaller manufacturers and distributors, non-habitational real estate and certain real property owner, landlord and tenant risks. Excess provides excess and umbrella liability coverages over our own and other carriers' primary casualty policies, with a focus on construction risks. Surety provides payment and performance bonds primarily to the environmental remediation and construction industries. Our healthcare line provides customized liability insurance solutions primarily for long-term care facilities.

In our ART line, specialty programs facilitate the offering of insurance to homogeneous niche groups through third party program managers. Our fully funded business provides a mechanism for insureds to post collateral so as to self-insure their risks and we are paid a fee for arranging this type of transaction.

In our Assumed Re line, the Company provides both traditional and structured specialty property and casualty reinsurance for unaffiliated specialty insurers and reinsurers with a focus on small specialty insurers, risk retention groups and captives.

The Other segment consists of amounts associated with the Company's investment in real estate which was essentially completed in 2005, and lines of business that we have placed in run-off, such as workers' compensation, excess liability insurance for municipalities plus commercial lines and ancillary product lines.

The Company measures all segments using net earnings, total assets and total equity. The reportable insurance operations segments are measured by net premiums earned, incurred losses and loss adjustment expenses and acquisition expenses. Assets are not allocated to the reportable insurance operations segments.

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The following table presents key financial data by segment for the three months ended June 30, 2009 and June 30, 2008 (dollars in thousands):

| June 30, 2009                     | Insurance |               |              |           |          |          |            |                        |                       |                 |        | Total     |
|-----------------------------------|-----------|---------------|--------------|-----------|----------|----------|------------|------------------------|-----------------------|-----------------|--------|-----------|
|                                   | E&S       |               |              |           |          |          |            | Assumed<br>Reinsurance | ART                   |                 | Other  |           |
|                                   | Property  | Environmental | Construction | Liability | Excess   | Surety   | Healthcare |                        | Specialty<br>Programs | Fully<br>Funded |        |           |
| Gross premiums written            | \$ 2,736  | \$10,405      | \$ 6,314     | \$ 2,233  | \$ 1,447 | \$ 3,153 | \$ 3,382   | \$ 9,830               | \$ 17,228             | \$ -            | \$ -   | \$ 56,728 |
| Net premiums written              | 2,424     | 8,712         | 5,255        | 1,879     | 243      | 2,192    | 2,198      | 9,848                  | 10,154                | -               | -      | 42,905    |
| Net premiums earned               | 1,647     | 9,451         | 6,052        | 1,482     | 207      | 2,233    | 2,296      | 8,386                  | 9,836                 | -               | -      | 41,590    |
| Fee income earned                 | -         | -             | -            | -         | -        | -        | -          | -                      | -                     | 883             | 301    | 1,184     |
| Losses & loss adjustment expenses | 1,017     | 6,190         | 3,367        | 817       | 135      | 893      | 1,194      | 5,484                  | 5,078                 | -               | -      | 24,175    |
| Acquisition expenses              | 358       | 2,346         | 1,347        | 307       | (152)    | 493      | 296        | 1,989                  | 1,889                 | -               | -      | 8,873     |
| Gross underwriting profit         | 272       | 915           | 1,338        | 358       | 224      | 847      | 806        | 913                    | 2,869                 | 883             | 301    | 9,726     |
| Income tax expense                |           |               |              |           |          | 677      |            |                        |                       |                 | 89     | 766       |
| Net earnings                      |           |               |              |           |          | \$ 6,790 |            |                        |                       |                 | \$ 222 | \$ 7,012  |

| June 30, 2008                     | Insurance |               |              |                       |         |          |            |                        |                       |                 |         | Total    |
|-----------------------------------|-----------|---------------|--------------|-----------------------|---------|----------|------------|------------------------|-----------------------|-----------------|---------|----------|
|                                   | E & S     |               |              |                       |         |          |            | Assumed<br>Reinsurance | ART                   |                 | Other   |          |
|                                   | Property  | Environmental | Construction | Products<br>Liability | Excess  | Surety   | Healthcare |                        | Specialty<br>Programs | Fully<br>Funded |         |          |
| Gross premiums written            | \$2,441   | \$13,085      | \$11,206     | \$1,748               | \$1,869 | \$2,594  | \$3,361    | \$20,102               | \$16,223              | \$ -            | \$ -    | \$72,629 |
| Net premiums written              | 1,715     | 9,694         | 8,689        | 1,411                 | 411     | 1,980    | 2,185      | 20,102                 | 11,054                | -               | -       | 57,241   |
| Net premiums earned               | 1,029     | 9,223         | 10,335       | 1,168                 | 183     | 1,726    | 637        | 14,419                 | 9,422                 | -               | -       | 48,142   |
| Fee income earned                 | -         | -             | -            | -                     | -       | -        | -          | -                      | -                     | 453             | 338     | 791      |
| Losses & loss adjustment expenses | 651       | 6,736         | 6,214        | 697                   | 109     | 596      | 331        | 9,915                  | 5,129                 | -               | 2       | 30,380   |
| Acquisition expenses              | 250       | 2,507         | 2,282        | 223                   | (212)   | 449      | 92         | 3,899                  | 2,472                 | -               | -       | 11,962   |
| Gross underwriting profit (loss)  | 128       | (20)          | 1,839        | 248                   | 286     | 681      | 214        | 605                    | 1,821                 | 453             | 336     | 6,591    |
| Income tax expense                |           |               |              |                       |         | 70       |            |                        |                       |                 | 25      | 95       |
| Net earnings                      |           |               |              |                       |         | \$ 3,789 |            |                        |                       |                 | \$3,014 | \$6,803  |

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The following table presents key financial data by segment for the six months ended June 30, 2009 and June 30, 2008 (dollars in thousands):

| June 30, 2009                     | Insurance |               |              |           |         |             |            |          | ART         |           | Other | Total       |       |
|-----------------------------------|-----------|---------------|--------------|-----------|---------|-------------|------------|----------|-------------|-----------|-------|-------------|-------|
|                                   | E & S     |               | Products     |           |         |             |            | Assumed  | Reinsurance | Specialty |       |             | Fully |
|                                   | Property  | Environmental | Construction | Liability | Excess  | Surety      | Healthcare | Programs | Funded      |           |       |             |       |
|                                   |           |               |              |           |         |             |            |          |             |           |       |             |       |
| Gross premiums written            | \$5,187   | \$22,818      | \$10,841     | \$4,216   | \$3,308 | \$5,754     | \$6,385    | \$18,228 | \$31,244    | \$ -      | \$ -  | \$107,621   |       |
| Net premiums written              | 4,210     | 18,825        | 8,978        | 3,530     | 499     | 4,068       | 4,150      | 18,732   | 19,644      | -         | -     | 82,269      |       |
| Net premiums earned               | 3,133     | 18,406        | 12,597       | 2,863     | 641     | 4,234       | 4,559      | 19,340   | 20,496      | -         | -     | 86,269      |       |
| Fee income earned                 | -         | -             | -            | -         | -       | -           | -          | -        | -           | 1,481     | 637   | 2,118       |       |
| Losses & loss adjustment expenses | 1,931     | 12,230        | 7,009        | 1,574     | 417     | 1,694       | 2,371      | 13,302   | 10,720      | -         | -     | 51,248      |       |
| Acquisition expenses              | 700       | 4,668         | 3,345        | 594       | (305)   | 1,145       | 388        | 4,302    | 4,240       | -         | -     | 19,077      |       |
| Gross underwriting profit         | 502       | 1,508         | 2,243        | 695       | 529     | 1,395       | 1,800      | 1,736    | 5,536       | 1,481     | 637   | 18,062      |       |
| Income tax expense                |           |               |              |           |         | 835         |            |          |             |           | 139   | 974         |       |
| Net earnings                      |           |               |              |           |         | \$ 12,138   |            |          |             |           | \$498 | \$12,636    |       |
| Assets                            |           |               |              |           |         | \$1,086,901 |            |          |             |           |       | \$1,086,901 |       |
| Equity                            |           |               |              |           |         | \$ 248,602  |            |          |             |           |       | \$ 248,602  |       |

  

| June 30, 2008                     | Insurance |               |              |           |         |            |            |           | ART       |           | Other   | Total     |       |
|-----------------------------------|-----------|---------------|--------------|-----------|---------|------------|------------|-----------|-----------|-----------|---------|-----------|-------|
|                                   | E & S     |               | Products     |           |         |            |            | Assumed   | Re        | Specialty |         |           | Fully |
|                                   | Property  | Environmental | Construction | Liability | Excess  | Surety     | Healthcare | Programs  | Funded    |           |         |           |       |
|                                   |           |               |              |           |         |            |            |           |           |           |         |           |       |
| Gross premiums written            | \$ 4,290  | \$26,332      | \$ 20,070    | \$ 3,113  | \$4,330 | \$4,619    | \$ 5,103   | \$ 28,628 | \$ 30,498 | \$ -      | \$ -    | \$126,983 |       |
| Net premiums written              | 3,012     | 18,621        | 14,902       | 2,491     | 632     | 3,677      | 3,317      | 28,628    | 20,469    | -         | -       | 95,749    |       |
| Net premiums earned               | 1,755     | 17,828        | 20,689       | 2,183     | 363     | 3,352      | 721        | 22,112    | 17,188    | -         | -       | 86,191    |       |
| Fee income earned                 | -         | -             | -            | -         | -       | -          | -          | -         | -         | 890       | 628     | 1,518     |       |
| Losses & loss adjustment expenses | 1,111     | 11,622        | 12,434       | 1,304     | 217     | 1,160      | 375        | 14,890    | 9,295     | -         | 2       | 52,410    |       |
| Acquisition expenses              | 412       | 4,696         | 4,569        | 373       | (360)   | 891        | 103        | 6,473     | 3,881     | -         | -       | 21,038    |       |
| Gross underwriting profit         | 232       | 1,510         | 3,686        | 506       | 506     | 1,301      | 243        | 749       | 4,012     | 890       | 626     | 14,261    |       |
| Income tax expense                |           |               |              |           |         | 170        |            |           |           |           | 73      | 243       |       |
| Net earnings                      |           |               |              |           |         | \$ 9,492   |            |           |           |           | \$3,470 | \$ 12,962 |       |
| Assets                            |           |               |              |           |         | \$ 958,967 |            |           |           |           | \$435   | \$959,402 |       |
| Equity                            |           |               |              |           |         | \$ 232,148 |            |           |           |           | \$(55)  | \$232,093 |       |



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The following table reconciles gross underwriting profit as shown above to our consolidated income before income taxes:

|   | Three Months Ended |                 | Six Months Ended |                  |
|---|--------------------|-----------------|------------------|------------------|
|   | June 30,           |                 | June 30,         |                  |
|   | <u>2009</u>        | <u>2008</u>     | <u>2009</u>      | <u>2008</u>      |
| Gross profit before operating expenses                  | \$ 9,726           | \$ 6,591        | \$ 18,062        | \$ 14,261        |
| Plus revenue not included in gross underwriting profit: |                    |                 |                  |                  |
| Net investment income                                   | 7,729              | 7,316           | 15,519           | 14,643           |
| Net realized gains                                      | 281                | 291             | 237              | 795              |
| Other income  | 66                 | 16              | 85               | 30               |
| Less expenses not included in gross profit:             |                    |                 |                  |                  |
| Payroll and related expenses                            | 5,704              | 5,374           | 11,522           | 9,859            |
| Other underwriting expenses                             | 2,766              | 3,000           | 5,795            | 6,316            |
| Interest expense  | 810                | 824             | 1,551            | 1,655            |
| Corporate and other expenses                            | <u>744</u>         | <u>(1,882)</u>  | <u>1,425</u>     | <u>(1,306)</u>   |
| Earnings before income taxes                            | <u>\$ 7,778</u>    | <u>\$ 6,898</u> | <u>\$ 13,610</u> | <u>\$ 13,205</u> |

Additionally, the Company conducts business in two geographic segments: the United States and Bermuda. Significant differences exist in the regulatory environment in each country. Those differences include laws regarding measurable information about the insurance operations by geographic segments. The following table provides key financial data about the geographic segments for the three months ended June 30, 2009 and June 30, 2008 (dollars in thousands):

| <b>June 30, 2009</b> | <b>United States</b> | <b>Bermuda</b> | <b>Total</b> |
|----------------------|----------------------|----------------|--------------|
| Income tax           | \$ 766               | \$ -           | \$ 766       |
| Net earnings         | \$ 2,604             | \$4,408        | \$ 7,012     |
| <br>                 |                      |                |              |
| <b>June 30, 2008</b> | <b>United States</b> | <b>Bermuda</b> | <b>Total</b> |
| Income tax           | \$ 95                | \$ -           | \$ 95        |
| Net earnings         | \$ 486               | \$6,317        | \$ 6,803     |

The following table provides key financial data about the geographic segments for the six months ended June 30, 2009 and June 30, 2008 (dollars in thousands):

| <b>June 30, 2009</b> | <b>United States</b> | <b>Bermuda</b> | <b>Total</b> |
|----------------------|----------------------|----------------|--------------|
| Income tax           | \$ 974               | \$ -           | \$ 974       |
| Net earnings         | \$ 3,185             | \$ 9,451       | \$ 12,636    |
| Assets               | \$ 613,415           | \$473,486      | \$1,086,901  |
| Equity               | \$ 92,718            | \$155,884      | \$ 248,602   |

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| <b>June 30, 2008</b> | <b>United States</b> | <b>Bermuda</b> | <b>Total</b> |
|----------------------|----------------------|----------------|--------------|
| Income tax           | \$ 243               | \$ -           | \$ 243       |
| Net earnings         | \$ 1,100             | \$ 11,862      | \$ 12,962    |
| Assets               | \$ 540,990           | \$418,412      | \$ 959,402   |
| Equity               | \$ 81,130            | \$150,963      | \$ 232,093   |

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**Note 5 - Income Taxes**

Total income tax expense for the periods ended June 30, 2009 and 2008 (dollars in thousands) was allocated as follows:

|   | Three Months Ended      |                | Six Months Ended        |                |
|---|-------------------------|----------------|-------------------------|----------------|
|   | June 30,<br><u>2009</u> | <u>2008</u>    | June 30,<br><u>2009</u> | <u>2008</u>    |
| Tax expense attributable to:                                      |                         |                |                         |                |
| Income from operations  | \$ 766                  | \$ 95          | \$ 974                  | \$ 243         |
| Change in unrealized gain (loss) on hedging transactions          | 717                     | 5              | 516                     | (54)           |
| Change in unrealized gain (loss) on securities available for sale | <u>2,876</u>            | <u>(2,023)</u> | <u>2,587</u>            | <u>(1,748)</u> |
| Total   | \$4,359                 | \$ (1,923)     | \$4,077                 | \$(1,559)      |

United States federal and state income tax expense (benefit) from operations consists of the following components (dollars in thousands):

|                               | Three Months Ended      |             | Six Months Ended        |             |
|-------------------------------|-------------------------|-------------|-------------------------|-------------|
|                               | June 30,<br><u>2009</u> | <u>2008</u> | June 30,<br><u>2009</u> | <u>2008</u> |
| Current                       | \$ 1,190                | \$ (166)    | \$ 1,532                | \$ (163)    |
| Deferred                      | (117)                   | 248         | (207)                   | 447         |
| Change in valuation allowance | <u>(307)</u>            | <u>13</u>   | <u>(351)</u>            | <u>(41)</u> |
| Total                         | \$ 766                  | \$ 95       | \$ 974                  | \$ 243      |

The state income tax expense provided for was \$64 for the three months ended June 30, 2009 and 2008, and \$77 and \$78 for the six months ended June 30, 2009 and 2008, respectively, and is included in the current provision.

Income tax expense for the periods ended June 30, 2009 and 2008 differed from the amount computed by applying the United States Federal income tax rate of 34% to earnings before Federal income taxes as a result of the following:

|  | Three Months Ended      |             | Six Months Ended        |             |
|--|-------------------------|-------------|-------------------------|-------------|
|  | June 30,<br><u>2009</u> | <u>2008</u> | June 30,<br><u>2009</u> | <u>2008</u> |
| Expected income tax expense                        | \$ 2,645                | \$ 2,345    | \$ 4,627                | \$ 4,489    |
| Foreign earned income not subject to U.S. taxation | (1,500)                 | (2,149)     | (3,214)                 | (4,033)     |
| Minority interest                                  | (32)                    | (4)         | (58)                    | (51)        |
| Change in valuation allowance                      | (307)                   | 14          | (351)                   | (41)        |



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|                       |           |             |            |             |
|-----------------------|-----------|-------------|------------|-------------|
| Tax-exempt interest   | (65)      | (50)        | (135)      | (99)        |
| State taxes and other | <u>25</u> | <u>(61)</u> | <u>105</u> | <u>(22)</u> |
| Total                 | \$ 766    | \$ 95       | \$ 974     | \$ 243      |

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**Note 6 - Employee Stock Options**

The Company's incentive stock plan grants incentive stock options to employees. The majority of the options outstanding under the plan vest evenly over a three year period and have a term of 10 years. The Company uses the Black-Scholes option pricing model to value stock options. The Company's methodology for valuing options has not changed from December 31, 2008. During the first six months of 2009, the Company granted 135,576 options compared to 136,302 for the same period of 2008. No options were granted for the three months ended June 30, 2009 or 2008. Stock based compensation expense related to outstanding options was \$231 for the three months ended June 30, 2009 and 2008 and \$489 and \$387, for the six months ended June 30, 2009 and 2008, respectively, and is reflected in net earnings under payroll and related expenses.

In addition to stock options discussed above, the Company may grant restricted shares to employees under the incentive stock plan. During the first six months of 2009, the Company granted 90,224 shares of restricted stock. The restricted shares vest on the grant date anniversary ratably over three years at 25%, 25% and 50%, respectively. Stock based compensation expense related to the restricted shares was \$244 and \$504 for the three and six months ended June 30, 2009 respectively, and is reflected in net earnings under payroll and related expenses. For the three and six months ended June 30, 2008, \$112 and \$130, respectively, were recorded in expense.

**Note 7 – Acquisition of Victore Insurance Company, Victore Enterprises, Inc. and Agency Bonding Company, Inc.**

On June 30, 2009, American Safety Casualty Insurance Company (ASCIC), a wholly owned subsidiary of American Safety Insurance Holdings, Ltd., acquired 100% voting equity of Victore Insurance Company (VIC), an Oklahoma domiciled admitted insurance company based in Oklahoma City, Victore Enterprises, Inc., an Oklahoma based holding company and Agency Bonding Company, Inc., an Oklahoma based insurance agency, for a purchase price of \$4.7 million. The three companies together are referred to as The Victore Companies.

Victore has generated approximately \$4 million of surety annual gross written premiums primarily in the Midwest. The additions of VIC expands the geographic perspective of our existing surety business which is more concentrated in the east and west coasts and adds an underwriting expertise in the energy sector.

The purchase was accounted for under the guidance of SFAS 141(R) as a business combination under the acquisition method. All identifiable assets and liabilities acquired were recognized using fair value measurement.

The assets and liabilities acquired were valued as follows (dollars in thousands):

|                        |          |
|------------------------|----------|
| Cash                   | \$ 1,002 |
| Bonds                  | 405      |
| Stocks                 | 167      |
| Short-term investments | 2,088    |
| Accounts Receivable    | 508      |
| Intangible asset       | 325      |
| Other assets           | 451      |
| Unpaid losses          | (920)    |

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|                   |       |
|-------------------|-------|
| Unearned premium  | (308) |
| Other liabilities | (460) |
| Goodwill          | 1,432 |

Pursuant to the purchase agreement, an Escrow Fund Holdback was established to reimburse the purchaser for any aggregate net claims or losses incurred by VIC from any bonds written by VIC prior to the "Closing Date" which, in the net aggregate, exceeded the total loss reserves as reflected in the

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purchase price. For a period of eighteen (18) months after the Closing Date ( the "Loss Holdback Period"), if the aggregate net claims incurred by VIC for bonds written prior to the Closing Date exceed the amount of total reserves purchased, the purchaser will be reimbursed from the Escrow Fund. A "Loss Fund Holdback" was also established to reimburse the purchaser for loss, cost and expense related to any breach of representations, warranties or covenants made by the sellers in the purchase agreement. At the end of the 18 month "Loss Holdback Period", the remaining funds will be disbursed to the seller. The Company believes that the reserves established at the date of acquisition were adequate to cover the losses that might be incurred for bonds written prior to the Closing Date.

The goodwill is attributable to the revenue stream and book of business in place currently and expected to continue to generate cash flow in the future. The Company will perform impairment testing each year at December 31 to determine whether there has been no impairment of the asset on an ongoing basis.

The Company does not expect the acquisition to have a material impact on earnings for 2009.

### **Note 8 – Fair Value Measurements**

Effective January 1, 2008 on a prospective basis, we determined the fair values of certain financial instruments based on the fair value hierarchy established in Statement of Financial Accounting Standard 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

To measure fair value, we obtain quoted market prices for our available-for-sale securities.

Assets measured at fair value on a recurring basis are summarized below:

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As of June 30, 2009  
 Fair Value Measurements Using  
 (dollars in thousands)

|                        | Quoted Prices in Active<br>Markets for Identical<br>Assets<br><u>(Level 1)</u> | Significant Other<br>Observable Inputs<br><u>(Level 2)</u> | Significant<br>Unobservable Inputs<br><u>(Level 3)</u> | <u>Total</u>   |
|------------------------|--|--|--|----------------|
| Fixed maturities       | \$ 28,267  | \$ 576,372   | \$ -   | \$ 604,639     |
| Equities securities    | 12,409   | -  | 5,082  | 17,491         |
| Short term investments | <u>111,265</u>   | <u>-</u>   | <u>-</u>   | <u>111,265</u> |
| Total                  | \$ 151,941   | \$576,372  | \$ 5,082   | \$ 733,395     |

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| Level 3 Financial Instruments  | Fair Value Measurements<br>Using Significant<br>Unobservable Inputs (Level 3)<br>(dollars in thousands)<br>Fixed |          |
|--|--|----------|
|  | Maturities   | Equities |
| Balance at December 31, 2008   | \$ 7,407   | \$ 5,082 |
| Total gains(losses) realized (unrealized):                                     |  |          |
| Included in earnings   | -  | -        |
| Included in other comprehensive income   | -  | -        |
| Net purchases  | -  | -        |
| Net transfers in (out of) Level 3  | (7,407)  | -        |
| Balance at June 30, 2009   | \$ -   | \$ 5,082 |
| Change in net unrealized gains relating to assets still held at reporting date | \$ -   | \$ -     |

On a quarterly basis, we evaluate whether the fair values of the Company's individual securities are other-than-temporarily impaired when the fair value is below amortized cost. To make this assessment we consider several factors including (i) our intent and ability to hold the security, (ii) the potential for the security to recover in value, (iii) an analysis of the financial condition of the issuer, (iv) an analysis of the collateral structure and credit support of the security, if applicable, (v) the time during which there has been a decline below cost, and (vi) the extent of the decline below cost. If we conclude a security is other-than-temporarily impaired, we write down the amortized cost of the security to fair value, with a charge to net realized investment losses in the Consolidated Statements of Operations. There were no other-than-temporary-impairments recorded for the three and six months ended June 30, 2008 and 2009, respectively.

In addition to the fair value estimates on our investments, in accordance with FSP-107-1, the Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which it is practicable to estimate such value:

- Cash and cash equivalents – The carrying amounts approximate fair value because of the short-term maturity of those instruments.
- Premiums receivable – The carrying value of premiums receivable approximates fair value due to the short-term nature.
- Long-term debt – The carrying value of those notes is a reasonable estimate of fair value.

#### Note 9 – Loans Payable

##### *Trust Preferred Offerings*

In 2003, American Safety Capital and American Safety Capital II, both non-consolidated, wholly-owned subsidiaries of the Company, issued \$8 million and \$5 million, respectively, of variable rate 30-year trust preferred securities. The proceeds are being used by the Company to support the growth of its insurance business. The securities require interest payments on a quarterly basis calculated at a floating rate of LIBOR + 4.2%

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and LIBOR + 3.95% for American Safety Capital and American Safety Capital II, respectively. The securities can be redeemed at the Company's option commencing five years from the date of original issuance.

In 2005, the American Safety Capital Trust III, a non-consolidated wholly-owned subsidiary of the Company, issued a 30-year trust preferred obligation in the amount of \$25 million. This obligation bears a fixed interest rate of 8.31% for the first five years and LIBOR + 3.4% thereafter. Interest is payable on

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a quarterly basis and the securities may be redeemed at the Company's option commencing five years from the date of original issuance.

The underlying debt obligations between the Company and American Safety Capital, American Safety Capital II and American Safety Capital III expose the Company to variability in interest payments due to changes in interest rates. Management entered into interest rate swaps for these trust preferred offerings to hedge that variability. Under each interest rate swap, the Company receives variable interest payments and makes fixed interest rate payments to the applicable capital trust entity, thereby creating fixed rate long-term debt. The overall effective fixed rate expense as a result of this hedge is 7.32% and 7.1% for American Safety Capital and American Safety Capital II, respectively, over the remaining term of the obligation. With an effective date of December, 2010, the swap on American Safety Capital III will result in a fixed rate of 7.50% over the remaining life of the obligation.

During May 2009 the Company terminated an interest rate swap entered in January 2009 on the American Safety Capital III. This transaction resulted in a \$2.3 million realized gain during the second quarter ended June 30, 2009.

Changes in fair value of the interest rate swaps designated as hedging instruments of the variability of cash flow associated with a floating rate, long-term debt obligation are reported in accumulated other comprehensive income. The gross unrealized gains on the interest rate swaps at June 30, 2009 were \$345, \$219 and \$954 for American Safety Capital, American Safety Capital II and American Safety Capital III, respectively.

### **Note 10 – Subsequent Events**

The Company evaluated subsequent events through the filing date of this Form 10Q quarterly filing, which was August 10, 2009, and determined there were none.

### **Note 11 - Accounting Pronouncements**

During the last two years, the Financial Accounting Standard Board (FASB) has issued a number of accounting pronouncements with various future effective dates.

On June 30, 2009, the Company adopted FAS 165, “Subsequent Events”(“FAS 165”), which provides guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FAS 165 also requires disclosure of the date through which subsequent events were evaluated as well as the rationale for why that date was selected. The adoption of FAS 165 did not have an impact on the Company’s financial position or results of operations. See Note 10.

In December 2007, the FASB issued SFAS 141(R), “Business Combinations” (“SFAS 141(R)”). SFAS 141(R) expands on the guidance of SFAS 141, extending its applicability to all transactions and other events in which an entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed and interests transferred as a result of business combinations. SFAS 141(R) expands on required disclosures to improve the statement users’ abilities to evaluate the nature and financial effects of business combinations. SFAS 141(R) establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including non-controlling interest, contingent consideration and certain acquired contingencies. SFAS 141(R) also requires acquisition-related transaction expenses and restructuring cost be expensed as incurred rather than capitalized as a component of the business combination. SFAS 141(R) is effective for any acquisitions made on or after January 1, 2009. On June 30, 2009, the Company acquired Victore Insurance Company. The Company accounted for the acquisition in



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accordance with SFAS 141(R) accounting, "Business Combinations".

In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, "Effective Date of FASB Statement No. 157" ("FSP No. 157-2"), which delays the effective date of SFAS 157 for non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. The Company has fully adopted SFAS 157 including FSP No. 157-2 effective January 1, 2009 and will be using the guidance and measuring the impact on our non-financial assets as a part of impairment testing.

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In March 2008, the FASB issued SFAS No. 161, "Disclosures About Derivative Instruments and Hedging Activities — an amendment of FASB Statement No. 133" ("SFAS 161"). SFAS No. 161 enhances the disclosure requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", regarding an entity's derivative instruments and hedging activities. SFAS No. 161 is effective for the Company's fiscal year beginning January 1, 2009 and has been adopted by the Company. During the quarter, the Company qualified for hedge accounting on three interest rate swap transactions.

On October 10, 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active ("FSP FAS 157-3")". FSP FAS 157-3 clarifies the application of FAS 157 in a market that is not active and illustrates key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application should be accounted for as a change in accounting estimate. The disclosure provisions of SFAS No. 154, "Accounting Changes and Error Corrections" for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application. The adoption of FSP FAS 157-3 did not have a material impact on the Company's results of operations, financial condition, or cash flows.

In April 2009, the FASB issued FSP FAS 157-4 "Determining Whether a Market is Not Active and a Transaction Is Not Distressed ("FSP FAS 157-4"). FSP FAS 157-4 provides additional guidance on factors to consider in estimating fair value when there has been a significant decrease in market activity for a financial asset. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009. The implementation of this standard did not have a material impact on our consolidated financial position and results of operations.

FSP 107-1 and APB 28-1 amends FAS No. 107, "Disclosures about Fair Value of Financial Instruments", to require disclosures in the body or in the accompanying notes to financial statements for interim reporting periods and in financial statements for annual reporting periods for the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the balance sheet. This FSP also amends APB opinion No. 28, "Interim Financial Reporting", to require entities to disclose the methods and significant assumptions used to estimate the fair value of financial instruments and describe changes in methods and significant assumptions in both interim and annual financial statements. FSP 107-1 and APB 28-1 are effective for interim reporting periods ending after June 15, 2009. The Company adopted this FSP for the quarter ended June 30, 2009 and there has been no material impact as a result of adoption.

The objective of FSP 115-2 and 124-2, which amend existing other-than-temporary impairment guidance for debt securities, is to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. Specifically, the recognition guidance contained in FSP 115-2 and 124-2 applies to debt securities classified as available-for-sale and held-to-maturity that are subject to other-than-temporary impairment guidance within FAS 115, FSP 115-1 and 124-1, FSP EITF 99-20-1 and American Institute of Certified Public Accountants Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer".

Among other provisions, FSP-115-2 and 124-2 requires entities to: (1) split other-than-temporary impairment charges between credit losses (i.e., the loss based on the entity's estimate of the decrease in cash flows, including those that result from expected voluntary prepayments), which are charged to earnings, and the remainder of the impairment charge (non-credit component) to other comprehensive income, net of applicable income taxes; (2) disclose information for interim and annual periods that enables financial statement users to understand the types of available-for-sale and held-to-maturity debt and equity securities held, including information about investments in an unrealized loss position for which an other-than-temporary impairment has or has not been recognized, and (3) disclose for interim and annual periods information that enables users of financial statements to understand the reasons that a portion of an other-than-temporary impairment of a debt security was not recognized in earnings and the

methodology and significant inputs used to calculate the portion of the total other-than-temporary impairment that was recognized in earnings.

FSP 115-2 and 124-2 are effective for interim reporting periods ending after June 15, 2009. For debt securities held at the beginning of the interim period of adoption for which an other-than-temporary impairment was previously recognized, if an entity does not intend to sell and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, the entity shall recognize the cumulative effect of initially applying this FSP as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income and the impact of adoption accounted for as a change in accounting principles, with applicable disclosure provided. The Company adopted FSP 115-2 and 124-2 during the quarter ended June 30, 2009 and this adoption did not have an impact on any of the other-than-temporary charges to date.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

We are a Bermuda-based specialty insurance and reinsurance company that provides customized products and solutions to small and medium-sized businesses in industries that we believe are underserved by the standard market. For over twenty years, we have developed specialized coverages and alternative risk transfer products not generally available to our customers in the standard market because of the unique characteristics of the risks involved and the associated needs of the insureds. We specialize in underwriting these products for insureds with certain environmental, products liability, construction, healthcare and property risks, as well as developing programs for other specialty classes of risks and providing third party reinsurance.

We segregate our business into insurance operations and other, with the insurance operations being further classified into three lines of operation: excess and surplus lines (E&S), alternative risk transfer (ART) and assumed reinsurance (Assumed Re). E&S is further classified into seven business lines: environmental, construction, products liability, excess, property, surety and healthcare. ART is further classified into two business lines: specialty programs and fully funded. In our Assumed Re segment, the Company assumes specialty property and casualty business from affiliated and unaffiliated insurers and reinsurers.

Within the E&S line, our environmental insurance coverages protect against general liability and environmental exposures for contractors and consultants in the environmental remediation industry and property owners. Construction provides commercial general liability insurance for residential and commercial contractors. Products liability offers general liability and product liability coverages for smaller manufacturers and distributors, non-habitational real estate and certain real property owner, landlord and tenant risks. Excess provides excess and umbrella liability coverages over our own and other carriers' primary casualty policies, with a focus on construction risks. Our property coverage encompasses non-standard, surplus lines commercial property business and commercial multi-peril (CMP) policies. The casualty focus of our CMP products is premises liability. Surety provides payment and performance bonds primarily to the environmental remediation and construction industries. Our healthcare line provides customized liability insurance solutions primarily for long-term care facilities.

In our ART line, specialty programs facilitate the offering of insurance to homogeneous niche groups of risks and we receive a fee for arranging this type of transaction. Our specialty programs consist primarily of property and casualty insurance coverages for certain classes of specialty risks including, but not limited to, construction contractors, pest control operators, small auto dealers, real estate brokers, consultants, restaurant and tavern owners, bail bondsmen and parent/teacher associations. Fully funded policies give our insureds the ability to fund their liability exposure via a self-insurance vehicle. We write fully funded general and professional liability for businesses operating primarily in the healthcare and construction industries.

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Our assumed reinsurance line offers property and casualty reinsurance products in the form of treaty and facultative contracts. We provide this coverage on an excess of loss and quota share basis. Our primary focus is our casualty business, which includes general liability, commercial auto, professional liability and workers' compensation. The Company provides both traditional and structured reinsurance targeting small specialty insurers, risk retention groups and captives.

Our Other segment includes lines of business that we have placed in run-off, such as workers' compensation, excess liability insurance for municipalities and commercial lines, plus real estate and other ancillary product lines.

The following information is presented on the basis of accounting principles generally accepted in the United States of America ("GAAP") and should be read in conjunction with our unaudited consolidated financial statements and the related notes included elsewhere in this report. All amounts and percentages are rounded.

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The table below summarizes the Company's net premiums written and net premiums earned by business line, consolidated revenues and percentage change year over year:

|                                      | Three Months Ended |               | Six Months Ended |               | Three Months Ended | Six Months Ended |
|--------------------------------------|--------------------|---------------|------------------|---------------|--------------------|------------------|
|                                      | June 30,           |               | June 30,         |               | June 30,           | June 30,         |
|                                      | <u>2009</u>        | <u>2008</u>   | <u>2009</u>      | <u>2008</u>   | <u>2009/2008</u>   | <u>2009/2008</u> |
|                                      | (in thousands)     |               | (in thousands)   |               |                    |                  |
| <b>Net premiums written:</b>         |                    |               |                  |               |                    |                  |
| Excess and Surplus Lines Segment     |                    |               |                  |               |                    |                  |
| Environmental                        | \$ 8,712           | \$ 9,694      | \$18,825         | \$18,620      | (10.1)%            | 1.1%             |
| Construction                         | 5,255              | 8,689         | 8,978            | 14,902        | (39.5)%            | (39.8)%          |
| Products Liability                   | 1,879              | 1,411         | 3,530            | 2,491         | 33.2%              | 41.7%            |
| Excess                               | 243                | 410           | 499              | 632           | (40.7)%            | (21.0)%          |
| Property                             | 2,424              | 1,715         | 4,210            | 3,012         | 41.3%              | 39.8%            |
| Surety                               | 2,192              | 1,980         | 4,068            | 3,677         | 10.7%              | 10.6%            |
| Healthcare                           | <u>2,198</u>       | <u>2,185</u>  | <u>4,150</u>     | <u>3,317</u>  | 0.6%               | 25.1%            |
| Total Excess & Surplus Lines Segment |                    |               |                  |               |                    |                  |
|                                      | 22,903             | 26,084        | 44,260           | 46,651        | (12.2)%            | (5.1)%           |
| Alternative Risk Transfer Segment    |                    |               |                  |               |                    |                  |
| Specialty Programs                   | <u>10,154</u>      | <u>11,055</u> | <u>19,644</u>    | <u>20,469</u> | (8.2)%             | (4.0)%           |
| Assumed Reinsurance Segment          |                    |               |                  |               |                    |                  |
|                                      | <u>9,848</u>       | <u>20,102</u> | <u>18,732</u>    | <u>28,628</u> | (51.0)%            | (34.6)%          |
| <b>Total net premiums written</b>    | \$42,905           | \$57,241      | \$82,636         | \$95,748      | (25.0)%            | (13.7)%          |
| <b>Net premiums earned:</b>          |                    |               |                  |               |                    |                  |
| Excess and Surplus Lines Segment     |                    |               |                  |               |                    |                  |
| Environmental                        | \$ 9,451           | \$ 9,223      | \$18,406         | \$17,829      | 2.5%               | 3.2%             |
| Construction                         | 6,052              | 10,335        | 12,597           | 20,688        | (41.4)%            | (39.1)%          |
| Products Liability                   | 1,482              | 1,168         | 2,863            | 2,183         | 26.9%              | 31.1%            |
| Excess                               | 207                | 183           | 641              | 363           | 13.1%              | 76.6%            |
| Property                             | 1,647              | 1,029         | 3,133            | 1,755         | 60.1%              | 78.5%            |
| Surety                               | 2,233              | 1,726         | 4,234            | 3,352         | 29.4%              | 26.3%            |
| Healthcare                           | <u>2,296</u>       | <u>637</u>    | <u>4,559</u>     | <u>721</u>    | 260.4%             | 532.3%           |

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Total Excess & Surplus  
Lines

|                                      |              |               |               |               |         |         |
|--------------------------------------|--------------|---------------|---------------|---------------|---------|---------|
| Segment                              | 23,368       | 24,301        | 46,433        | 46,891        | (3.8)%  | (1.0)%  |
| Alternative Risk Transfer<br>Segment |              |               |               |               |         |         |
| Specialty Programs                   | <u>9,836</u> | <u>9,422</u>  | <u>20,496</u> | <u>17,188</u> | 4.4%    | 19.2%   |
| Assumed Reinsurance<br>Segment       | <u>8,386</u> | <u>14,419</u> | <u>19,340</u> | <u>22,112</u> | (41.8)% | (12.5)% |
| <b>Total net premiums<br/>earned</b> | \$41,590     | \$48,142      | \$86,269      | \$ 86,191     | (13.6)% | 0.1%    |
| Net investment income                | 7,729        | 7,316         | 15,519        | 14,643        | 5.6%    | 6.0%    |
| Net realized gains                   | 281          | 291           | 237           | 795           | (3.4)%  | (70.2)% |
| Fee income                           | 1,184        | 791           | 2,118         | 1,518         | 49.8%   | 39.5    |
| Other income                         | <u>66</u>    | <u>16</u>     | <u>84</u>     | <u>30</u>     | 312.5%  | 180.0%  |
| <b>Total revenues</b>                | \$50,850     | \$56,556      | \$104,227     | \$103,177     | (10.1)% | 1.1%    |

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The following table sets forth the components of our GAAP combined ratio for the periods indicated:

|                                      | Three Months Ended |              | Six Months Ended |              |
|--------------------------------------|--------------------|--------------|------------------|--------------|
|                                      | June 30,           |              | June 30,         |              |
|                                      | <u>2009</u>        | <u>2008</u>  | <u>2009</u>      | <u>2008</u>  |
| Loss & loss adjustment expense ratio | 58.1%              | 63.1%        | 59.4%            | 60.8%        |
| Expense ratio                        | <u>38.9%</u>       | <u>40.6%</u> | <u>39.7%</u>     | <u>41.4%</u> |
| Combined ratio                       | 97.0%              | 103.7%       | 99.1%            | 102.2%       |

### Three Months Ended June 30, 2009 compared to

### Three Months Ended June 30, 2008

#### Net Earnings

Net earnings increased 1.5% to \$6.9 million, or \$.66 per diluted share, for the three months ended June 30, 2009, compared to \$6.8 million, or \$.63 per diluted share, for the same period of 2008. The increase in net earnings was driven by improved underwriting results, higher fee income and increased investment income, partially offset by a higher effective tax rate. See discussion below for more information regarding the various components of net earnings.

#### Net Premiums Earned

#### *Excess and Surplus Lines*

*Environmental.* Net premiums earned increased 2.5% to \$9.5 million for the three months ended June 30, 2009, compared to \$9.2 million for the same period of 2008. Net premiums earned have increased as a result of company retaining more of the insurance risk. The Company cedes approximately 10% less premium and risk to third parties under the Company's core casualty reinsurance treaty with an effective date of September 1, 2008 than it did under the treaty in effect during the 2008 period.

*Construction.* Net premiums earned decreased 41.4% to \$6.0 million for the three months ended June 30, 2009, compared to \$10.3 million for the same period of 2008. The decline was primarily due to lower premium writings driven by reduced renewal retention rates and lower levels of new business in both its western and non-western states as the Company continues to exercise underwriting discipline in a more competitive market, the effects of a slowing housing market and the impact of a soft insurance market.

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*Products Liability.* The Company's products liability line produced \$1.5 million of net premiums earned for the three months ended June 30, 2009 compared to \$1.2 million for the same period of 2008. This line continues to experience growth as the Company gains recognition in the marketplace. The products are offered to small and middle market accounts including smaller manufacturers, distributors, non-habitational real estate and certain owner, landlord and tenant risks.

*Excess.* Net premiums earned remained flat at \$0.2 million for the three months ended June 30, 2009, compared to \$0.2 million for the comparable period of 2008. The Company's excess product offering is focused primarily in the construction and products liability areas.

*Property.* The Company's property and commercial multi-peril line produced net premiums earned of \$1.6 million for the three months ended June 30, 2009 as compared to \$1.0 million for the three months ended June 30, 2008. Net premiums earned increased due to the growth in gross premiums written as the Company continues to build this book of business and capitalize on opportunities as other carriers exit certain sectors and geographic areas.

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*Surety.* Net premiums earned increased 29.4% to \$2.2 million for the three months ended June 30, 2009, compared to \$1.7 million for the same period of 2008. The increase is due to growth in premium writings in the Company's specialty surety, environmental and small contractor books of business.

*Healthcare.* Net premiums earned for the three months ended June 30, 2009 were \$2.3 million, an increase of 260.4% over the same period in 2008. This product line was acquired through the acquisition of the LTC Companies in February 2008. The premiums and policies in force were not acquired, resulting in the lower earned premiums in the 2008 quarter.

### ***Alternative Risk Transfer Segment***

*Specialty Programs.* Net premiums earned increased 4.4% to \$9.8 million for the three months ended June 30, 2009 compared to \$9.4 million for the same period in 2008. Net premiums earned increased primarily due to increased retention levels in our specialty programs, as well as new programs being earned for a full year for the period ended June 30, 2009.

### ***Assumed Reinsurance Segment***

*Reinsurance.* This line of business generated \$8.4 million in net premiums earned for the three months ended June 30, 2009 compared to \$14.4 million for the same period of 2008, a decrease of 42%. The decrease in premiums earned was attributable to the impact of a non-recurring reinsurance transaction with gross written premiums of \$12.4 million booked during the 2008 quarter.

### **Fee Income Earned**

Fee income earned increased 49.8% to \$1.2 million for the three months ended June 30, 2009 as compared to \$0.8 million for the same period of 2008. The increase is primarily attributable to the fee income associated with the fully funded business.

### **Net Investment Income**

Net investment income increased 5.6% to \$7.7 million for the three months ended June 30, 2009 compared to \$7.3 million for the same period of 2008. This increase was due to an increase in average invested assets. Average invested assets increased to \$709 million at June 30, 2009 from \$601 million at June 30, 2008 primarily due to cash flow from operations. The average pre-tax and after-tax investment yields were 4.4% and 3.7% compared to 4.9% and 4.2% for the three months ended June 30, 2009 and 2008, respectively.

### **Net Realized Gains (Losses)**

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Net realized gains from the sale of investments were \$0.3 million for the three months ended June 30, 2009 and for the same period of 2008. During May, 2009 the Company terminated an interest rate swap on certain of its trust preferred debt resulting in a realized gain of \$2.3 million. Based upon market opportunities that arose during the second quarter, we decided to reshape the investment portfolio to take advantage of these market opportunities. We chose to sell \$71 million of fixed maturity securities and \$7 million of equity securities during the second quarter, resulting in a realized loss of \$2.1 million. The actions taken to reshape the portfolio during the quarter were completed by quarter end. This reshaping allowed the Company to improve the credit quality of the portfolio with no material impact on investment income.

### **Losses and Loss Adjustment Expenses**

Losses and loss adjustment expenses totaled \$24.2 million, or 58.1% of net premiums earned, for the three months ended June 30, 2009 compared to \$30.4 million, or 63.1%, for the same period of 2008. The decrease in the loss ratio was due to improved current accident year underwriting results and prior year adverse reserve development of \$1.5 million in the 2008 quarter. There was no prior year development in the 2009 quarter.

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### **Acquisition Expenses**

Policy acquisition expenses are amounts paid to producers of premiums, offset by ceding commissions we receive from reinsurers. Policy acquisition expenses also include premium taxes paid to states in which we are admitted to conduct business. Policy acquisition expenses decreased to \$8.9 million for the three months ended June 30, 2009 as compared to \$12.0 million for the same period of 2008, and, as a percentage of net premiums earned, decreased to 21.3% for the three months ended June 30, 2009 compared to 24.8% for the same period of 2008. The decrease is due to a decline in acquisition costs in our assumed reinsurance business resulting from a shift to excess of loss treaties from quota share which carry higher acquisition costs.

### **Payroll and Other Underwriting Expenses**

Payroll and other underwriting expenses increased 6.1% to \$5.7 million for the three months ended June 30, 2009, compared to \$5.4 million for the same 2008 period due to normal salary increases and increases in the bonus accrual. Included in other underwriting expenses are \$0.1 million in legal costs associated with the Victore acquisition expensed according to FAS 141(R).

### **Corporate and Other Expenses**

Corporate and other expenses increased to \$0.7 million for the three months ended June 30, 2009, compared to \$(1.9) million for the same 2008 period. This increase was due to an adjustment made in the 2008 quarter for \$2.8 million, reducing the accrued warranty liability established in 2004 associated with our former real estate project in Florida, which was substantially completed in 2005.

### **Income Taxes**

Income tax expense for the three months ended June 30, 2009 was \$0.8 million, or 10%, of pre-tax income, compared to \$0.1 million, or 1.4%, for the same period of 2008. The higher tax rate in the second quarter of 2009 was due primarily to higher earnings in our U.S. operations.

### **Combined Ratio**

Our underwriting results are best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and loss adjustment expenses to net premiums earned (loss ratio) and (b) the ratio of policy acquisition costs and other operating expenses to net premiums earned (expense ratio). A combined ratio below 100% indicates that an insurer has an underwriting profit, and a combined ratio above 100% indicates that an insurer has an underwriting loss.

The combined ratio decreased to 97.0% for the three months ended June 30, 2009 from 103.7% for the same period of 2008. The decrease was primarily attributable to a reduction in the loss ratio which was a combination of the mix of business and \$1.5 million in adverse reserve

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development in the 2008 quarter. The expense ratio decrease is driven by lower acquisition costs in the assumed reinsurance line. Corporate and other expense increased by \$2.6 million as a result of a \$2.8 million reduction in warranty expense related to a former real estate project in Florida booked in the 2008 quarter.

**Six Months Ended June 30, 2009 compared to**

**Six Months Ended June 30, 2008**

### **Net Earnings**

Net earnings decreased 2.7% to \$12.5 million, or \$1.19 per diluted share, for the six months ended June 30, 2009, compared to \$12.8 million, or \$1.21 per diluted share, for the same period of 2008. See explanations below for the various components of net earnings.

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## Net Premiums Earned

### *Excess and Surplus Line*

*Environmental.* Net premiums earned increased 3.2% to \$18.4 million for the six months ended June 30, 2009, as compared to \$17.8 million for the same period of 2008, due to company retaining more of the insurance risk.

*Construction.* Net premiums earned decreased 39.1% to \$12.6 million for the six months ended June 30, 2009 as compared to \$20.7 million for the same period in 2008. The Company has seen a significant decline in its construction gross written premiums book of business since 2006. The principal reason driving the decline was lower new business writings and lower renewal retention rates as the Company continues to exercise underwriting discipline in a more competitive market. The effects of a depressed housing market and a slowing economy also translated into lower average premiums per account and a reduction in audit premiums.

*Products Liability.* Net premiums earned increased to \$2.9 million for the six months ended June 30, 2009, an increase of 31.1% as compared to \$2.2 million for the same period of 2008. This line continues to experience growth as the Company gains recognition in the marketplace. The products are offered to small and middle market accounts including smaller manufacturers, distributors, non-habitational real estate and certain owner, landlord and tenant risks.

*Excess.* Net premiums earned were \$0.6 million for the six months ended June 30, 2009, an increase of 76.6% compared to \$0.4 for the same period of 2008. The Company's excess product offering is focused primarily in the construction and product liability areas.

*Property.* The Company's property and commercial multi-peril line produced net premiums earned of \$3.1 million for the six months ended June 30, 2009 as compared to \$1.8 million in net premiums earned for the six months ended June 30, 2008. Net premiums earned increased due to the growth in gross premiums written as the Company continues to build this book of business.

*Surety.* Net premiums earned increased 26.3% to \$4.2 million for the six months ended June 30, 2009 as compared to \$3.4 million for the same period of 2008. The increase in surety premiums is attributable to the growth in written premiums in the Company's specialty surety, environmental and small contractors books of business.

*Healthcare.* ASI Healthcare provides insurance and risk management solutions for the long-term care industry. Net premiums earned for the six months ended June 30, 2009 were \$4.6 million compared to \$0.7 million for the same period of 2008. This product line was acquired through the acquisition of the LTC Companies in February 2008. The premiums and policies in force were not acquired, resulting in the lower earned premiums in the 2008 quarter.

### *Alternative Risk Transfer*

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*Specialty Programs.* Net premiums earned increased 19.2% to \$20.5 million for the six months ended June 30, 2009 as compared to \$17.2 million for the same period of 2008. Net premiums earned increased due primarily to increased retention levels in our specialty programs, as well as new programs being earned for a full year for the period ended June 30, 2009.

### *Assumed Reinsurance*

This line of business generated \$19.3 million in net premiums earned for the six months ended June 30, 2009, a decrease of 12.5% as compared to \$22.1 million for the same period of 2008. The decrease is primarily due to the impact of a non-recurring reinsurance transaction with gross written premiums of \$12.4 million booked in the second quarter of 2008.

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### **Fee Income Earned**

Fee income earned increased 39.5% to \$2.1 million for the six months ended June 30, 2009 as compared to \$1.5 million for the same period of 2008. The increase is primarily attributable to increased fully funded fee income business.

### **Net Investment Income**

Net investment income increased 6% to \$15.5 million for the six months ended June 30, 2009 as compared to \$14.6 million for the same period of 2008. The increase is due to increased average invested assets resulting from cash flow from operations. Average invested assets increased to \$702.2 million at June 30, 2009 from \$607.4 million at June 30, 2008, reflecting positive cash flow from operations. The average pre-tax and after-tax investment yields were 4.4% and 3.8%, respectively for the six months ended June 30, 2009, compared to 4.8% and 4.1%, respectively for the six months ended June 30, 2008.

### **Net Realized Gains (Losses)**

Net realized gains from the sale of investments were \$0.2 million for the six months ended June 30, 2009, compared to \$0.8 million for the same period of 2008. During May, 2009 the Company terminated an interest rate swap on certain of its trust preferred debt resulting in a realized gain of \$2.3 million. Based upon market opportunities that arose during the second quarter, we decided to reshape the investment portfolio to take advantage of these market opportunities. We chose to sell \$71 million of fixed maturity securities and \$7 million of equity securities during the second quarter, resulting in a realized loss of \$2.1 million. The actions taken to reshape the portfolio during the quarter were completed by quarter end. This reshaping allowed the Company to improve the credit quality of the portfolio with no material impact on investment income.

### **Losses and Loss Adjustment Expenses**

Losses and loss adjustment expenses totaled \$51.2 million, or 59.4% of net premiums earned, for the six months ended June 30, 2009, compared to \$52.4 million, or 60.8%, for the same 2008 period. The decrease is attributable to improved current accident year underwriting results and prior year adverse reserve development of \$1.5 million in the 2008 period. There was no prior year development in the 2009 period.

### **Acquisition Expenses**

Policy acquisition expenses are amounts paid to producers of premiums, brokers in our assumed reinsurance business, offset by ceding commissions we receive from our reinsurers. Policy acquisition expenses also include premium taxes paid to states in which we are admitted to conduct business. Policy acquisition expenses decreased to \$19.0 million for the six months ended June 30, 2009 as compared to \$21.0 million for the same period of 2008, and, as a percentage of net premiums earned, decreased to 22.1% for the six months ended June 30, 2009 compared to 24.4% for the same period of 2008. The decrease is due to a decline in acquisition costs in our assumed reinsurance business resulting from a shift to excess of loss treaties from quota share which carry higher acquisition costs.

**Payroll and Other Underwriting Expenses**

Payroll and other underwriting expenses increased 7.1% to \$17.3 million for the six months ended June 30, 2009, compared to \$16.2 million for the same 2008 period. The increase is due to normal salary increases and increased bonus and severance accruals. Included in other underwriting expenses are \$0.1 million in legal costs associated with the Victore acquisition expensed according to FAS 141(R).

**Corporate and Other Expenses**

Corporate and other expenses increased to \$1.4 million for the six months ended June 30, 2009, compared to \$(1.3) million for the same 2008 period. This increase was due to an adjustment made

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in the 2008 quarter for \$2.8 million, reducing the accrued warranty liability established in 2004 associated with our former real estate project in Florida, which was substantially completed in 2005.

### Income Taxes

Income tax expense for the first six months of 2009 was \$1.0 million or 7.2% of pre-tax income, compared to \$0.2 million or 1.8% of pre-tax income for the same period of 2008. The higher tax rate is due to increased earnings in the U.S. subsidiaries.

We are incorporated under the laws of Bermuda and, under current Bermuda law, are not obligated to pay taxes in Bermuda based upon income or capital gains. We have received an undertaking from the Minister of Finance in Bermuda pursuant to the provisions of The Exempted Undertakings Tax Protection Act 1966, which exempts us and our shareholders, other than shareholders ordinarily resident in Bermuda, from any Bermuda taxes computed on profits, income or any capital asset, gain or appreciation, or any tax in the nature of estate, duty or inheritance until March 28, 2016. Exclusive of our United States subsidiaries, we do not consider ourselves to be engaged in a trade or business in the United States and accordingly, do not expect to be subject to direct United States income taxation. Our U.S. subsidiaries are subject to taxation in the United States.

### Liquidity and Capital Resources

The Company meets its cash requirements and finances its growth principally through cash flows generated from operations. Due to the soft market, the Company has experienced a reduction in premium rates due to the entrance of new insurance competitors and overall market conditions. The Company's primary sources of short-term cash flow are premium writings and investment income. Short-term cash requirements relate to claims payments, ceded reinsurance premiums, commissions, salaries, employee benefits and other operating expenses. Due to the uncertainty regarding the timing and amount of settlements of unpaid claims, the Company's future liquidity requirements may vary; therefore, the Company has structured its investment portfolio maturities to help mitigate the variations in those factors. The Company believes its current cash flows are sufficient for the short-term needs of its business and its invested assets are sufficient for the long-term needs of its insurance business.

Net cash provided by operations was \$26.7 million for the six months ended June 30, 2009 compared to net cash provided by operations of \$0.5 million for the same period of 2008.

Net cash used in investing activities was \$25.9 million for the six months ended June 30, 2009 compared to net cash used in investing activities of \$2.9 million for the same period of 2008. Cash flows generated from operations were used to purchase additional investments and fund the purchase of Victore.

Net cash provided by financing activities was \$4 thousand for the six months ended June 30, 2009 as compared to net cash used in financing activities of \$3.7 million for the same period of 2008. During the corresponding 2008 period, there were stock repurchases of \$4.1 million.

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Our ability to pay future dividends to shareholders will depend, to a significant degree, on the ability of our subsidiaries to generate earnings from which to pay dividends. The jurisdictions in which we and our insurance and reinsurance subsidiaries are domiciled places limitations on the amount of dividends or other distributions payable by insurance companies in order to protect the solvency of insurers. Given our growth and the capital requirements associated with that growth, we do not anticipate paying dividends on the common shares in the near future.

### **Combined Ratio**

Our underwriting results are best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and loss adjustment expenses to net premiums earned (loss ratio) and (b) the ratio of

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policy acquisition costs and other operating expenses to net premiums earned (expense ratio). A combined ratio below 100% indicates that an insurer has an underwriting profit, and a combined ratio above 100% indicates that an insurer has an underwriting loss.

The combined ratio decreased to 99.1% for the six months ended June 30, 2009 from 102.2% for the same period of 2008. The decrease was attributable to a reduction in the expense ratio of 2.3 percentage points driven by lower acquisition costs in the assumed reinsurance business attributed to a shift from quota share to excess of loss treaties. The loss ratio decreased by 1.4 percentage points due primarily to one reinsurance treaty in our assumed reinsurance product line that was non-renewed as well as the switch to excess of loss from quota share treaties.

The expense ratio portion of our reported combined ratio excludes interest expense, fee income and corporate and other expenses. These excluded amounts totaled approximately \$ 2.7 million and \$(0.3) million for the three months ended June 30, 2009 and 2008, respectively, and \$5.1 million and \$1.9 million for the six months ended June 30, 2009 and 2008, respectively.

### *Forward-Looking Statements*

This report contains forward-looking statements. These forward-looking statements reflect the Company's current views with respect to future events and financial performance, including insurance market conditions, premium growth, acquisitions, cash flow, investments, losses, expenses, ratios, reserves, new products and the impact of new accounting standards. Forward-looking statements involve risks and uncertainties which may cause actual results to differ materially, including competitive conditions in the insurance industry, levels of new and renewal insurance business, developments in loss trends, adequacy and changes in loss reserves and actuarial assumptions, other than temporary impairments, timing or collectability of reinsurance recoverables, market acceptance of new coverages and enhancements, changes in reinsurance costs and availability, potential adverse decisions in court and arbitration proceedings, the integration and other challenges attendant to acquisitions, and changes in levels of general business activity and economic conditions.

Actual results may differ materially from the results suggested by the forward-looking statements for a number of reasons. We have made these statements based on our plans and analyses of our company, our business and the insurance industry as a whole. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could over time prove to be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this report will themselves prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of this information should not be regarded as a representation by us or any other person that our objectives will be achieved. We expressly disclaim any obligation to update any forward-looking statement unless required by law.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

For an in-depth discussion of the Company's market risks, see Management's Discussion and Analysis of Quantitative and Qualitative Disclosures about Market Risk in Item 7A of the Company's Form 10-K for the year ended December 31, 2008 and "Part II Other Information", Item 1A-Risk Factors" herein.

### **Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

The Company's management, with the participation of the Company's Chief Executive Officer and Interim Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Report, concluded that, as of such date, the Company's disclosure controls and procedures were adequate

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and effective to ensure that material information relating to the Company (including consolidated subsidiaries) would be made known to them.

**Changes in Internal Control**

There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation described above that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company, through its subsidiaries, is routinely party to pending or threatened litigation or arbitration disputes in the normal course of or related to its business. Based upon information presently available, in view of legal and other defenses available to our subsidiaries, management does not believe that any pending or threatened litigation or arbitration disputes will have any material adverse effect on our financial condition or operating results.

**Item 1A. Risk Factors**

Our business is subject to the following risk factors, among others, in addition to the information (including disclosures relative to forward-looking statements) set forth elsewhere in this report.

**Risk Factors Relating to American Safety Insurance**

*A downgrade in our A.M. Best rating or increased capital requirements could impair our ability to sell insurance policies.*

On October 29, 2008, A.M. Best, the most widely recognized insurance company rating agency, affirmed its rating of “A” (Excellent) on a group basis of American Safety Insurance, including our U.S. insurance subsidiaries, our Bermuda reinsurance subsidiary and our U.S. non-subsiary risk retention group affiliate. A. M. Best also affirmed the rating outlook of stable. An “A” (Excellent) rating is the third highest of fifteen ratings assigned by A.M. Best to companies that have, in the opinion of A.M. Best, an excellent ability to meet their ongoing obligations to policyholders.

Some insureds are required to obtain insurance coverage from insurance companies that have an “A-” (Excellent) rating or higher from A.M. Best. Additionally, many producers are prohibited from placing insurance or reinsurance with companies that are rated below “A-” (Excellent) by A.M. Best. A.M. Best assigns ratings that represent an independent opinion of a company’s ability to meet its obligations to policyholders that is of concern primarily to policyholders, brokers and agents, and its rating and outlook should not be considered an investment recommendation. Because A.M. Best continually monitors companies with regard to their ratings, our ratings could change at any time, and any downgrade of our current rating may impair our ability to sell insurance policies and, ultimately, our financial condition and operating results.

If A.M. Best requires us to increase our capital in order to maintain our rating and we are unable to raise the required amount of capital to be contributed to our subsidiaries, A.M. Best may downgrade our rating.

*The exclusions and limitations in our policies may not be enforceable.*

We draft the terms and conditions of our excess and surplus lines policies to manage our exposure to expanding theories of legal liability in business lines such as asbestos abatement, construction defect, environmental and professional liability. Many of the policies we issue include exclusions or other conditions that define and limit coverage. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought against our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion or limitation, or legislation could be enacted modifying or barring the use of these exclusions and limitations particularly with respect to evolving business lines such as construction defect. This could result in higher than anticipated losses and loss adjustment expenses by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a material adverse effect on our operating results. In some instances, these changes may not become apparent until some time after we have issued the insurance policies that

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are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a policy is issued.

### *The risks we underwrite are concentrated in relatively few industries.*

We focus much of our underwriting on specialty risks in the construction and environmental remediation industries. As a result of our diversification efforts, for the six months ended June 30, 2009, approximately 33.6% of our gross written premiums were written in these two industries compared to 35.0% for 2008. However, our operating results could be more exposed than our more diversified competitors to unfavorable changes in business, economic or regulatory conditions, changes in federal, state or local environmental standards and establishment of legal precedents affecting these industries. Similarly, a significant incident impacting one of these industries that has the effect of increasing claims generally (or their settlement value) could negatively impact our financial condition and operating results.

### *We may respond to market trends by expanding or contracting our underwriting activities in certain business lines, which may cause our financial results to be volatile.*

Although we perform due diligence and risk analysis before entering into a new business line or insuring a new type of risk, and carefully assess the impact of exiting a business line, changing business lines inherently has more risk than remaining in the same business lines over a period of time. Because we actively seek to expand or contract our capacity in the markets we serve in response to factors such as loss experience and premium production, our operating results may experience material fluctuations.

### *Our industry is highly competitive and we may lack the financial resources to compete effectively.*

We believe that competition in the specialty insurance markets that we target is fragmented and not dominated by one or more competitors. We face competition from several types of companies, such as insurance companies, reinsurance companies, underwriting agencies, program managers and captive insurance companies. Many of our competitors are significantly larger and possess greater financial, marketing and management resources than we do. We compete on the basis of many factors, including coverage availability, claims management, payment terms, premium rates, policy terms, types of insurance offered, overall financial strength, financial strength ratings and reputation. If any of our competitors offer premium rates, policy terms or types of insurance that are more competitive than ours we could lose business. If we are unable to compete effectively in the markets in which we operate or to establish a competitive position in new markets, our financial condition and operating results would be adversely impacted.

### *Our actual incurred losses may be greater than reserves for our losses and loss adjustment expenses.*

Insurance companies are required to maintain reserves to cover their estimated liability for losses and loss adjustment expenses with respect to both reported and incurred but not reported ("IBNR") claims. Reserves are estimates at a given time involving actuarial and statistical projections of what we expect to be the cost of the ultimate resolution and administration of claims. These estimates are based on facts and circumstances then known, predictions of future events, estimates of future trends, projected claims frequency and severity, potential judicial expansion of liability precedents, legislative activity and other factors, such as inflation. Our in-house actuarial staff reviews the reserves of our major lines on a quarterly basis and a full actuarial analysis annually. In addition, an independent third party actuarial firm performs a full actuarial analysis annually, which includes assessing the adequacy of statutory reserves.



Notwithstanding these efforts, the establishment of adequate reserves for losses and loss adjustment expenses is an inherently uncertain process, particularly in the environmental remediation industry, construction industry and some of the other industries for which we write policies where extensive historical data may not exist or where the risks insured are long-tail in nature, in that claims that have occurred may not be reported to us for long periods of time. For instance, there is little empirical data for residential construction defect claims and hence, traditional actuarial analysis may be inapplicable or less reliable. Due to these uncertainties, our ultimate losses could materially exceed our reserves for losses and

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loss adjustment expenses, especially in business lines where we have increased or intend to increase our risk retention.

To the extent that reserves for losses or loss adjustment expenses are estimated in the future to be inadequate, we would have to increase our reserves and incur charges to earnings in the periods in which the reserves are increased. In addition, increases in reserves may also cause additional reinsurance premiums to be payable to our reinsurers. These increases in reserves and reinsurance premiums would adversely impact our financial condition and operating results. For more information on our losses and loss adjustment expenses, see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

*If we are unable to obtain reinsurance on favorable terms, our ability to write new policies could be adversely affected.*

Reinsurance is a contractual arrangement under which one insurer (the ceding company) transfers to another insurer (the reinsurer) a portion of the liabilities that the ceding company has assumed under an insurance policy it has issued. Our business involves ceding portions of the risks that we underwrite to reinsurers. The availability and cost of reinsurance are subject to prevailing market conditions that are beyond our control and are factors that could materially impact our financial condition and operating results. There is no certainty that reinsurance will continue to be available in the form or in the amount that we require or, if available, at an affordable cost. The availability of reinsurance is dependent not only on reinsurers' reactions to the specific risks that we underwrite, but also events that impact the overall reinsurance industry. If we are unable to maintain or replace our reinsurance, our total loss exposure would increase and, if we were unwilling or unable to assume that increase in exposure, we would be required to mitigate the increase in exposure by writing fewer policies or writing policies with lower limits or different coverage.

*We may be unable to recover amounts due from our reinsurers.*

While reinsurance contractually obligates the reinsurer to reimburse us for a portion of our losses, it does not relieve us of our primary financial liability to our insureds. If our reinsurers are either unwilling or unable to pay some or all of the claims made by us on a timely basis, we bear the financial exposure. As a result, we are subject to credit risk with respect to our reinsurers. The total amount of reinsurance recoverables at June 30, 2009 was \$200.5 million, or 81.8% of shareholders' equity. Of this amount, \$81.6 million, or approximately 40.7% of the total recoverable amount, is collateralized by cash, irrevocable letters of credit or other acceptable forms of collateral posted by the reinsurer.

We purchase reinsurance from reinsurers we believe to be financially sound. We have written reinsurance security procedures that establish financial requirements for reinsurance companies that must be met prior to reinsuring any of the business we write. Among these requirements is a stipulation that reinsurance companies must have an A.M. Best rating of at least "A-" (Excellent) and a financial size category of Class VIII or greater at the time of writing any reinsurance unless sufficient collateral has been provided at the time we enter into our reinsurance agreement. A financial size category of Class VIII is assigned by A.M. Best to companies with adjusted policyholder surplus of \$100 million to \$250 million, which, on a statutory basis of accounting, is the amount remaining after all liabilities, including loss reserves, are subtracted from all admitted assets. We have also established an internal reinsurance security committee, consisting of members of senior management, which meets quarterly to discuss and approve reinsurance security and evaluate collectability of reinsurance recoverables. To protect against our reinsurers inability to satisfy their contractual obligations to us, our reinsurance contracts stipulate a collateral requirement for reinsurance companies that do not meet the financial strength and size requirements described above. These collateral requirements can be met through the issuance of unconditional letters of credit, the establishment and funding of escrow accounts for our benefit or cash advances paid into a segregated account. In the event collateral is not sufficient, there is no certainty that these reinsurers will be able to provide additional collateral or fulfill their obligations to us.



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We are unable to ensure the credit worthiness of our reinsurers. In prior years, A.M. Best and Standard and Poor's ("S&P"), downgraded the financial strength ratings of the insurance and reinsurance operating subsidiaries of Alea Group Holdings (Bermuda) Ltd., including among others, Alea North American Insurance Company and Alea London Limited ("Alea"), one of our reinsurers. Subsequently, Alea requested that A.M. Best withdraw all ratings of Alea. A.M. Best currently has assigned a NR-4 (Company Request) to Alea. As of June 30, 2009, our unsecured estimated net exposure to Alea was approximately \$10.0 million, primarily in our specialty programs. This estimate is based upon our estimates of losses and will not reflect our exposure if our actual losses differ from those estimates.

The Company had an allowance of \$3.8 million as of June 30, 2009 and December 31, 2008.

*We rely on independent insurance agents and brokers to market our products.*

We market most of our insurance products through approximately 250 independent insurance agents and brokers, which we refer to as producers. These producers are not obligated to promote our products and may sell competitors' products. Our profitability depends, in part, on the marketing efforts of these producers and on our ability to offer insurance products and services while maintaining financial strength ratings that meet the requirements of our producers and their customers. The failure or inability of producers to market our insurance products successfully would have a material adverse effect on our business and operating results. As of June 30, 2009, the Company has no individual producers that generate greater than 10% of gross premiums written.

*We are subject to credit risk in connection with producers that market our products.*

In accordance with industry practice, when the insured pays premiums for our policies to producers for payment over to us, these premiums are considered to have been paid and, in most cases, the insured is no longer liable to us for those amounts, whether or not we actually have received the premiums. Consequently, we assume a degree of credit risk associated with the producers with whom we choose to do business. To date, we have not experienced any material losses related to these credit risks.

*Our long-term growth strategy is dependent on several factors, the failure to achieve any one of which may impair our ability to expand our operations or may prevent us from operating profitably.*

Our long-term growth strategy includes expanding in our existing markets, entering new geographic markets, creating relationships with new producers and developing new insurance products. In order to generate this growth, we are subject to various risks, including risks associated with our ability to:

- identify insurable risks not adequately served by the standard insurance market;
- maintain adequate levels of capital;
- obtain reinsurance on favorable terms;
- obtain necessary regulatory approvals when writing on an admitted basis;
- attract and retain qualified personnel to manage our expanded operations;
- complete acquisitions of small specialty insurers, general agents or lines of business,
- invest in products and markets that positively impact near term results; and
- maintain our financial strength ratings.

Our inability to achieve any of the above objectives could affect our long-term growth strategy and may cause our business and operating results to suffer.

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*If we lose key personnel or are unable to recruit qualified personnel, our ability to implement our business strategies could be delayed or hindered.*

Our future success will depend, in part, upon the efforts of our executive officers and other key personnel. Our ability to recruit and retain key personnel will depend upon a number of factors, such as our results of operations, business prospects and the level of competition then prevailing in the market for qualified personnel. The loss of any of these officers or other key personnel or our inability to recruit key personnel could prevent us from fully implementing our business strategies and could materially adversely affect our business, financial condition and operating results.

*We routinely evaluate opportunities to expand our business through acquisitions of other companies or business lines. There are many risks associated with acquisitions that we may be unable to control.*

We evaluate potential acquisition opportunities as a means to grow our business. There are a number of risks attendant to any acquisition. These risks include, among others, the difficulty in integrating the operations and personnel of an acquired company; potential disruption of our ongoing business; inability to successfully integrate acquired systems and insurance programs into our operations; maintenance of uniform standards, controls and procedures; possible impairment of relationships with employees and insureds of an acquired business as a result of changes in management; and that the acquired business may not produce the level of expected profitability. As a result, the impact of any acquisition on our future performance may not be consistent with original expectations, and may impair our business, financial condition and operating results.

*A prolonged economic downturn may have a negative impact on our financial results.*

We are subject to certain risks related to prolonged economic downturn as follows:

- reduced need for insurance;
- lower revenues of our insureds;
- increased claim settlement costs;
- decrease in investment yields;
- impairment of our investment portfolio;
- credit worthiness of our program managers, brokers and reinsurers;
- and
- ability to access capital markets at reasonable rates.

*We may require additional capital in the future, which may not be available or may only be available on unfavorable terms.*

Our future capital requirements depend on many factors, including our ability to write profitable new business, retain existing customers and establish premium rates and reserves at levels sufficient to cover losses and related expenses. Many factors will affect our capital needs and their amount and timing, including our growth and profitability, our claims experience and the availability of reinsurance, as well as possible acquisition opportunities, market disruptions, changes in regulatory requirements and other unforeseeable developments. If we have to raise additional capital, equity or debt financing may not be available at all or may be available only on terms that are unfavorable to us. In the case of

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equity financings, dilution to our shareholders could result. In the case of debt financings, we may be subject to covenants that restrict our ability to freely operate our business. If we cannot obtain adequate capital on favorable terms or at all, we may not have sufficient funds to implement our operating plans and our business, financial condition and operating results could be adversely affected.

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*Changes in the value of our investment portfolio may have a material impact on our operating results.*

We derive a significant portion of our net earnings from our invested assets. As a result, our operating results depend in part on the performance of our investment portfolio. As of June 30, 2009, the fair value of our investment portfolio was \$733.4 million and net investment income derived from these assets was \$15.5 million. We also incurred net realized gains of \$0.2 million, or 1.8 % of our pre-tax earnings. Our investment portfolio is subject to various risks, including:

- credit risk, which is the risk that our invested assets will decrease in value due to unfavorable changes in the financial prospects or a downgrade in the credit rating of an entity in which we have invested;
- interest rate risk, which is the risk that our invested assets or investment income may decrease due to changes in interest rates;
- equity price risk, which is the risk that we will incur economic loss due to a decline in equity prices;
- duration risk, which is the risk that our invested assets may not adequately match the duration of our insurance liabilities
- industry sector concentration risk, which is the risk that our invested assets are concentrated in a small number of investment sectors;
- mortgage-backed securities, which may have exposure to sub-prime mortgages although all mortgage-backed securities in the Company's portfolio are issued by Fannie Mae, Freddie Mac or Ginnie Mae; and
- general economic conditions that may negatively impact the volume or income stream from our invested amounts or require that we recognize losses on certain investments.

Our investment portfolio is comprised mostly of fixed-income securities. We do not hedge our investments against interest rate risk and, accordingly, changes in interest rates may result in fluctuations in the value of these investments.

Our investment portfolio is managed by an independent, nationally recognized investment management firm, in accordance with detailed investment policies and guidelines established by the Board of Directors, that stress preservation of principal with due consideration for operating income targets and the Company's overall asset/liability strategy. If our investment portfolios are not appropriately matched with the respective insurance and reinsurance liabilities, we may be forced to liquidate investments prior to their maturity at a significant loss in order to cover these liabilities. This might occur, for instance, in the event of a large or unexpected claim or series of claims. Large investment losses could significantly decrease our asset base, thereby affecting our ability to underwrite new business. For more information about our investment portfolio, see "Business-Investments."



*We rely upon the successful and uninterrupted functioning of our information technology, information processing and telecommunication systems.*

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology, information processing and telecommunications systems. We rely on these systems to support our marketing operations, process new and renewal business, provide customer service, make claims payments, and facilitate premium collections and policy cancellations. These systems also enable us to perform actuarial and other modeling functions necessary for underwriting and rate development. We have a highly trained staff that is committed to the continual development and maintenance of these systems. However, the failure of these systems could interrupt our operations or materially impact our

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ability to evaluate and write new business. Because our information technology, information processing and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for this service exceeds capacity or if the third party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to write and process new and renewal business and provide customer service or compromise our ability to pay claims in a timely manner. There can be no guarantee that these systems can effectively support our continued growth. Additionally, some of our systems are not fully redundant, and our disaster recovery planning does not account for all eventualities, which could adversely affect our business.

*We are subject to risks related to litigation.*

From time to time, we are subject to lawsuits and other claims arising out of our insurance, reinsurance and former real estate operations. We have responded to the lawsuits we face and, although the outcome of these lawsuits cannot be predicted, we believe that there are meritorious defenses and intend to vigorously contest these claims. Adverse judgments in one or more of these lawsuits could require us to change aspects of our operations in addition to paying significant damage amounts. In addition, the expenses related to these lawsuits may be significant. Lawsuits can have a material adverse effect on our business and operating results, particularly where we have not established an accrual or a sufficient accrual for damages, settlements or expenses. For information on the material litigation in which we are involved, see "Item 3 - Legal Proceedings".

*Catastrophe losses could materially reduce our profitability.*

We are exposed to claims arising out of catastrophes in our assumed reinsurance line of business. We can experience in the future, catastrophe losses which may materially reduce our profitability or harm our financial condition. Catastrophes can be caused by various natural events, including hurricanes, windstorms, earthquakes, hail, severe winter weather and fires. Catastrophes can also be man-made, such as the World Trade Center attack. The incidence and severity of catastrophes are inherently unpredictable. Although we will attempt to manage our exposure to such events, the frequency and severity of catastrophic events could exceed our estimates, which could have a material adverse effect on our financial condition.

**Risk Factors Related to Taxation**

*Our Bermuda operations may be subject to U.S. tax.*

American Safety Insurance Holdings, Ltd., its reinsurance subsidiary, American Safety Re and its segregated account captive, American Safety Assurance, are organized in Bermuda. American Safety Insurance Holdings, Ltd., American Safety Re and American Safety Assurance are operated in a manner such that none should be subject to U.S. tax (other than U.S. excise tax on insurance and reinsurance premium income attributable to insuring or reinsuring U.S. risks and U.S. withholding tax on some types of U.S. source investment income) because none of these companies should be treated as engaged in a trade or business within the U.S. (and, in the case of American Safety Re and American Safety Assurance, to be doing business through a permanent establishment within the U.S.). However, because there is considerable uncertainty as to the activities that constitute being engaged in a trade or business within the U.S. (and what constitutes a permanent establishment under the income tax treaty between the U.S. and Bermuda (the "Bermuda Treaty")) as well as the entitlement of American Safety Re and American Safety Assurance to treaty benefits), there can be no assurances that the U.S. Internal Revenue Service (the "IRS") will not contend successfully that American Safety Insurance Holdings, Ltd., American Safety Re and/or American Safety Assurance is engaged in a trade or business in the U.S. (or that American Safety Re or American Safety Assurance is carrying on business through a permanent establishment in the U.S.). If any of American Safety Insurance Holdings, Ltd., American Safety Re or American Safety Assurance were considered to be engaged in a trade or business in the U.S., it could be subject to U.S. corporate income and additional branch profits taxes on the portion of its earnings



effectively connected to such U.S. business, in which case its operating results could be materially adversely affected.

***If you acquire 10% or more of the Common Shares, you may be subject to taxation under the “controlled foreign corporation” (“CFC”) rules.***

Under certain circumstances, a “U.S. 10% shareholder” of a foreign corporation that is a CFC for an uninterrupted period of 30 days or more during a taxable year must include in gross income for U.S. federal income tax purposes that U.S. 10% shareholder’s “subpart F income,” even if the “subpart F income” is not distributed to that U.S. 10% shareholder. “Subpart F income” of a foreign insurance corporation typically includes foreign personal holding company income (such as interest, dividends and other types of passive income), as well as insurance and reinsurance income (including underwriting and investment income) attributable to the insurance of risks situated outside the CFC’s country of incorporation.

We believe that because of the dispersion of our Common Share ownership, provisions in our organizational documents that limit voting power and other factors, no U.S. person who acquires Common Shares directly or indirectly through one or more foreign entities should be required to include our “subpart F income” in income under the CFC rules of the Code. It is possible that the IRS could challenge the effectiveness of these provisions and that a court could sustain that challenge, in which case, one’s investment could be materially adversely affected.

***U.S. persons who hold Common Shares may be subject to U.S. federal income taxation at ordinary income rates on their proportionate share of our “related party insurance income” (“RPII”).***

If the RPII of American Safety Re or American Safety Assurance were to equal or exceed 20% of its gross insurance income in any taxable year and direct or indirect insureds (and persons related to those insureds) own directly or indirectly through entities 20% or more of the voting power or value of American Safety Re or American Safety Assurance, then a U.S. person who owns any Common Shares (directly or indirectly through foreign entities) on the last day of the taxable year would be required to include in income for U.S. federal income tax purposes that person’s pro rata share of that company’s RPII for the entire taxable year, determined as if that RPII were distributed proportionately only to U.S. persons at that date regardless of whether that income is distributed. In addition, any RPII that is includible in the income of a U.S. tax-exempt organization may be treated as unrelated business taxable income. Neither American Safety Re nor American Safety Assurance expects gross RPII to equal or exceed 20% of its gross income for 2008 or subsequent years, and neither expects its direct or indirect insureds (including related persons) to directly or indirectly hold 20% or more of its voting power or value, but we cannot be certain that this will be the case because some of the factors which determine the extent of RPII may be beyond our control. If these thresholds are met or exceeded, and if you are an affected U.S. person, your investment could be materially adversely affected. The RPII provisions, however, have never been interpreted by the courts or the U.S. Treasury Department (the “Treasury Department”) in final regulations, and regulations interpreting the RPII provisions of the Code exist only in proposed form. It is not certain whether these regulations will be adopted in their proposed form or what changes or clarifications might ultimately be made thereto or whether any of those changes, as well as any interpretation or application of RPII by the IRS, the courts or otherwise, might have retroactive effect. The Treasury Department has authority to impose, among other things, additional reporting requirements with respect to RPII. Accordingly, the meaning of the RPII provisions and the application thereof to us is uncertain.

***U.S. persons who dispose of Common Shares may be subject to U.S. federal income taxation at the rates applicable to dividends on a portion of their gain, if any.***

Section 1248 of the Internal Revenue Code of 1986, as amended (the “Code”) provides that if a U.S. person sells or exchanges stock of a foreign corporation and that person owned, directly, indirectly through certain foreign entities or constructively, 10% or more of the voting power of the corporation at any time during the five-year period ending on the date of disposition when the corporation was a CFC,



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any gain from the sale or exchange of the shares will be treated as a dividend to the extent of that person's share of the CFC's earnings and profits (determined under U.S. federal income tax principles) during the period that person held the shares and while the corporation was a CFC (with certain adjustments). We believe that because of the dispersion of our Common Share ownership, provisions in our organizational documents that limit voting power and other factors, no U.S. shareholder, other than Fredrick C. Treadway or Treadway Associates, L.P., of American Safety Insurance should be treated as owning (directly, indirectly through foreign entities or constructively) 10% or more of the total voting power of American Safety Insurance. As a result, American Safety Insurance should not be a CFC and Section 1248 of the Code, as applicable under the general CFC rules, should not apply to dispositions of our shares. It is possible, however, that the IRS could challenge these provisions in our organizational documents and that a court could sustain that challenge. To the extent American Safety Insurance is a CFC, a 10% U.S. Shareholder may in certain circumstances be required to report a disposition of Common Shares by attaching IRS Form 5471 to the U.S. federal income tax or information return that it would normally file for the taxable year in which the disposition occurs.

For purposes of Section 1248 of the Code and the requirement to file Form 5471, special rules apply with respect to a U.S. person's disposition of shares of a foreign insurance company that has RPII during the five-year period ending on the date of the disposition. In general, if a U.S. person disposes of shares in a foreign insurance corporation in which U.S. persons own 25% or more of the shares (even if the amount of gross RPII is less than 20% of the corporation's gross insurance income and the ownership of its shares by direct or indirect insureds and related persons is less than the 20% threshold), any gain from the disposition may be treated as a dividend to the extent of that person's share of the corporation's undistributed earnings and profits that were accumulated during the period that person owned the shares (whether or not those earnings and profits are attributable to RPII). As a result of these special rules and proposed Treasury Department regulations, the IRS may assert that Section 1248 of the Code and the requirement to file Form 5471 apply to dispositions of Common Shares because American Safety Insurance is engaged in the insurance business indirectly through subsidiaries.

***American Safety Insurance, American Safety Re, American Safety Assurance and Ordinance Holdings, Limited may become subject to Bermuda taxes in the future.***

Bermuda currently imposes no income taxes on corporations. American Safety Insurance, American Safety Re and American Safety Assurance have received an assurance from the Bermuda Minister of Finance, under the Exempted Undertakings Tax Protection Act 1966 of Bermuda, as amended (the "Tax Protection Act"), that if any legislation is enacted in Bermuda that would impose tax computed on profits or income, or computed on any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance tax, then the imposition of the tax will not be applicable to American Safety Insurance, American Safety Re or American Safety Assurance until March 28, 2016. No assurance can be given that American Safety Insurance, American Safety Re or American Safety Assurance will not be subject to any Bermuda tax after that date.

***The impact of Bermuda's letter of commitment to the Organization for Economic Cooperation and Development to eliminate harmful tax practices is uncertain and could adversely affect American Safety Insurance's, American Safety Re's, and American Safety Assurance's tax status in Bermuda.***

The Organization for Economic Cooperation and Development (the "OECD") has published reports and launched a global dialogue among member and non-member countries on measures to limit harmful tax competition. These measures are largely directed at counteracting the effects of tax havens and preferential tax regimes in countries around the world. In the OECD's report dated April 18, 2002 and updated as of June 2004, Bermuda was not listed as an uncooperative tax haven jurisdiction because it had previously committed to eliminate harmful tax practices and to embrace international tax standards for transparency, exchange of information and the elimination of any aspects of the regimes for financial and other services that attract business with no substantial domestic activity. We are not able to predict what changes will arise from the commitment or whether these changes will subject us to additional taxes.

**Risk Factors Relating to the Property and Casualty Insurance Industry**

*Policy pricing in our industry is cyclical, and our financial results are impacted by that cyclicity.*

The property and casualty insurance industry has historically been a cyclical industry consisting of both “soft market” periods and “hard market” periods. During soft market periods, insurers tend to be more aggressive in writing policies and competitive in the pricing of those premium rates. Beginning in 2000, we believe our industry experienced a hardening market, reflected by increasing rates and more restrictive coverage terms. These trends appeared to have started slowing in 2004. We believe the industry is now in a soft market where pricing generally has become more competitive and policy terms and conditions have become less restrictive. Therefore, we may not be able to achieve our growth and profitability goals. Because this cyclicity is due in large part to the economy, the particular needs of insureds and the actions of our competitors, we cannot predict the timing or duration of changes in the insurance market cycle.

*Our industry is subject to significant and increasing regulatory scrutiny.*

In recent years, the insurance industry has been subject to a significant and increasing level of scrutiny by various regulatory bodies, including state attorneys general and insurance departments, concerning certain practices within the insurance industry. These practices include the receipt of contingent commissions by insurance brokers and agents from insurance companies and the extent to which this compensation has been disclosed, bid rigging and related matters. As a result of these and related matters, there have been a number of recent revisions to existing, or proposals to modify or enact new, laws and regulations regarding the relationship between insurance companies and producers. Any changes or further requirements that are adopted by federal, state or local governments could adversely affect our business and operating results.

*We operate in a heavily regulated industry, and existing and future regulations may constrain how we conduct our business and could impose liabilities and other obligations upon us.*

**Insurance Regulation.** Our primary insurance and reinsurance subsidiaries, as well as our non-subsidiary risk retention group affiliate, are subject to regulation under applicable insurance statutes of the jurisdictions in which they are domiciled or licensed and write insurance. This regulation may limit our ability to, or speed with which we can, effectively respond to market opportunities and may require us to incur significant annual regulatory compliance expenditures. Insurance regulation is intended to provide safeguards for policyholders rather than to protect shareholders of our insurance companies. Insurance regulation relates to authorized business lines, capital and surplus requirements, types and amounts of investments, underwriting limitations, trade practices, policy forms, claims practices, mandated participation in shared markets, loss reserve adequacy, insurer solvency, transactions with related parties, changes in control, payment of dividends and a variety of other financial and non-financial components of an insurance company’s business. For instance, our insurance subsidiaries are subject to risk-based capital, or RBC, restrictions. RBC is a method of measuring the amount of capital appropriate for an insurance company to support its overall business in light of its size and risk profile. The ratio of a company’s actual policyholder surplus to its minimum capital requirements will determine whether any state regulatory action is required. State regulatory authorities use the RBC formula to identify insurance companies which may be undercapitalized and may require further regulatory attention. Each of our domestic insurance subsidiaries satisfies its minimum capital requirements and none of them is identified by any regulatory authority as being undercapitalized or requiring further regulatory attention. A number of legislative initiatives currently are under consideration by Congress. Any changes in insurance laws and regulations could materially adversely affect our operating results. We are unable to predict what additional laws and regulations, if any, affecting our business may be promulgated in the future or how they might be interpreted.

**Dividend Regulation.** Like other insurance holding companies, American Safety Insurance relies on dividends from its insurance subsidiaries to be able to pay dividends and fulfill its other financial





obligations. The payment of dividends by these subsidiaries and other intercompany transactions are subject to regulatory restrictions and will depend on the surplus and earnings of these subsidiaries. As a result, insurance holding companies may not be able to receive dividends from their subsidiaries at times and in amounts sufficient to pay dividends and fulfill their other financial obligations. Additionally, as a Bermuda holding company, American Safety Insurance is subject to Bermuda regulatory constraints that will affect its ability to pay dividends on the Common Shares and to make other payments. Under the Companies Act 1981, of Bermuda ("the Companies Act") insurance holding companies may declare or pay a dividend out of distributable reserves only if it has reasonable grounds to believe that it is, and would after the payment be, able to pay liabilities as they become due and if the realizable value of its assets would thereby not be less than the aggregate of its liabilities and issued share capital and share premium accounts. We do not anticipate paying cash dividends on the Common Shares in the near future.

**Environmental Regulation.** Environmental remediation activities and other environmental risks are heavily regulated by both federal and state governments. Environmental regulation is continually evolving and changes in the regulatory patterns at federal and state levels may have a significant affect upon potential claims against us and our insureds. These changes also may affect the demand for the types of insurance offered by and through us and the availability or cost to us of reinsurance. We are unable to predict what additional laws and regulations, if any, affecting environmental remediation activities and other environmental risks may be promulgated in the future, how they might be applied and what their impact might be.

**Changes in U.S. federal income tax law could materially adversely affect us.** Legislation has been introduced in the U.S. Congress intended to eliminate some perceived tax advantages of companies (including insurance companies) that have legal domiciles outside the United States but have certain U.S. connections. It is possible that such legislation could be introduced and enacted by the current Congress or future Congresses that could have an adverse impact on us.

The risk factors presented above are all of the ones that we consider to be material as of the date of this quarterly report on Form 10-Q. However, they are not the only risks facing the company. Additional risks not presently known to us, or which we consider immaterial based on our current knowledge or understanding, may also adversely affect us. There may be risks that a particular investor views differently than we do, and our analysis may be incorrect. If any of the risks that we face actually occurs, our business, financial condition and operating results could be materially adversely affected and could differ materially from any possible results suggested by any forward-looking statements that we have made or may make. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by law.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period            | (a) Total Number of Shares (or Units) Purchased | (b) Average Price Paid Per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|-------------------|---|--|---|---|
| 10/1 – 10/31/2007 | -   | -  | -   | 500,000   |
| 11/1 – 11/30/2007 | -   | -  | -   | 500,000   |
| 12/1 – 12/31/2007 | 27,300  | \$18.75                                    | 27,300  | 472,700   |
| 1/1 – 1/31/2008   | -   | -  | 27,300  | 472,700   |
| 2/1 – 2/29/2008   | -   | -  | 27,300  | 472,700   |
| 3/1 – 3/31/2008   | 116,500   | \$16.95                                    | 143,800   | 356,200   |
| 4/1 – 4/30/2008   | 10,900  | \$17.67                                    | 154,700   | 345,300   |
| 5/1 – 5/31/2008   | 93,850  | \$16.05                                    | 248,550   | 251,450   |
| 6/1 – 6/30/2008   | 10,000  | \$15.90                                    | 258,550   | 241,450   |
| 7/1 – 7/31/2008   | 141,765   | \$13.50                                    | 400,315   | 99,685  |
| 8/1 – 8/31/2008   | <u>99,685</u>                                   | <u>\$15.44</u>                             | 500,000   | -   |
| <b>Total</b>      | <b>500,000</b>                                  | <b>\$15.59</b>                             |   |   |

The Company completed a stock repurchase program for 500,000 shares of the Company's outstanding common stock on August 12, 2008.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None



**Item 6. Exhibits**

The following exhibits are filed as part of this report:

| <u>Exhibit No.</u> | <u>Description</u>  |
|--------------------|---|
| 11                 | Computation of Earnings Per Share                                 |
| 31.1               | Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2               | Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1               | Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2               | Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 10th day of August, 2009.

American Safety Insurance Holdings, Ltd.

By: /s/ Stephen R. Crim  
Stephen R. Crim  
President and Chief Executive Officer

By: /s/ Stephen R. Crim  
Stephen R. Crim  
Chief Financial Officer (Interim)